TAX EXPENDITURE LIMITATION AND CONTROL ACT OF 1981 (S. 193)

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BEFORE THE

COMMITTEE ON THE BUDGET

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TUESDAY, NOVEMBER 24, 1981

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 2:10 p.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman) presiding.

Present: Senators Domenici, Kassebaum, Gorton, Metzenbaum, and Moynihan.

Staff present: Peter Davis, senior economist for tax analysis; and Kemble Stokes, chief economist for the minority.

Chairman DOMENICI. The hearing will please come to order.

We have a number of witnesses. I apologize for starting late, but I guess based upon the traditions of this committee, we are starting very early. We are usually 45 minutes late; so today 10 minutes shouldn't interfere with our work.

Senator Kassebaum, I am going to have to leave early, and hopefully you will chair the hearings this afternoon.

OPENING STATEMENT OF CHAIRMAN DOMENICI

It is my pleasure to open this afternoon's hearings on S. 193, Senator Kassebaum's bill to limit revenue losses arising from tax expenditures. In the hectic opening months of the 97th Congress, we concentrated on revising Federal fiscal policy through the reconciliation process. We then turned our attention to the tax bill. And now, as we move into the second phase of our efforts to restore integrity to Federal fiscal policy, it is particularly appropriate that we hold hearings to consider ways of controlling tax expenditures.

TAX EXPENDITURE SIDE NEEDS CLOSE EXAMINATION

The Budget Act clearly places this responsibility on the Budget Committee. As Senator Kassebaum knows, I believe that the tax expenditure side of the budget needs a close examination. The multitude of provisions in the tax code exempting large amounts of income from taxes reflect Federal fiscal policy choices which are every bit as important in the budget context as are spending decisions. Yet tax expenditures receive substantially less attention in our ongoing budget work.

Tax expenditures will total $266 billion in fiscal 1982, and they are projected to grow by nearly 15 percent a year to $465 billion in fiscal 1986. Furthermore, these figures do not include the effect of the Economic Recovery Tax Act of 1981. This bill lowered the cost

of many present law tax expenditures because of reduced marginal tax rates, but it also added $11 billion of tax expenditures in fiscal 1982, $25 billion in fiscal 1983, and $42 billion in fiscal 1984.

During our recent deliberations on the second budget resolution for fiscal year 1982, I offered a plan which contemplated substantial improvement in the budget outlook through reduction of tax expenditures with the full understanding that we cannot mandate that. We can mandate a change in the revenue base. I proposed a second budget resolution which did not carry although it gained more votes than any other proposal. It lost by a vote of 10 to 12. It would have the Congress raise $48 billion in revenues during fiscal years 1983 and 1984 by closing off approximately 10 percent of the special exemptions, deductions, credits, and preferences which are now provided in our income tax laws.

IMPROVING THE TAX LAWS HAS SUPPORT

The Budget Committee was unable to reach substantive agreement on a second resolution for a number of reasons, but the debate and vote on my plan demonstrated that there is substantial support for a comprehensive effort to improve the fairness and equity of our tax laws.

Senator Kassebaum's efforts to focus congressional attention on tax expenditures are quite consistent with the duties of the Budget Committee spelled out in the Congressional Budget Act. Section 102(a) of that act states that the Budget Committee—

> * * * shall have the duty * * * to request and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays, and to report the results of such studies to the Senate on a recurring basis.

Senator Kassebaum's bill and her request for this hearing, are predicated on the idea that individual fiscal decisions, whether they affect entitlements, discretionary appropriations, revenue collections or tax expenditures, should not be made on an ad hoc basis. Rather, they must be made in the context of congressionally established overall spending and revenue policies.

Your bill focuses on an aspect of Federal fiscal policy which has largely been ignored in our effort to establish more appropriate spending and aggregate revenue policies. I commend you for your efforts to bring this matter to the attention of the Committee on the Budget and all of our colleagues in the Senate.

I look forward to reviewing the testimony taken today and working with the committee in an effort to comply with the mandate imposed upon us. I yield to the junior Senator from Kansas, Senator Kassebaum.

And then, Senator Kennedy, we will shortly get to you as our first witness.

Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR KASSEBAUM

This committee will in the near future begin deliberations on possible legislative improvements in the congressional budget process. This indeed is a tall order, but a very important one. Among

the important issues we will address as a Committee will be the need to amend the Budget Act in order to impose institutional restraints on the growth of tax expenditures, or tax benefits, or tax subsidies, whatever name we would care to use.

The Budget Act implicitly recognizes that Federal spending takes two distinct forms: direct spending and tax spending. Both mechanisms transfer revenues for purposes that are perceived to be in the national interest. Direct subsidies are provided through the congressional authorization and appropriations process. Tax subsidies are provided through special exclusions, deductions, credits, and preferential rates which exempt revenue from collection as required by the general provisions of the Federal tax code.

The degree of control exercised by this committee over the two approaches is vastly different. Through concurrent resolutions on the budget we set priorities to guide direct spending policies and channel limited resources in an orderly fashion. No such comparable vehicle exists for bringing order to tax spending. Budget resolutions set neither targets for tax expenditures nor do they allocate ceilings for tax subsidies by committee.

CONSIDERATION MUST BE GIVEN TO REVENUE LOSS FROM TAX EXPENDITURES

Clearly, efforts to control the ever-increasing revenue loss from tax expenditures must be given immediate consideration. Budgetary planning and control is, as we have all learned since 1974, no easy task. Even with the advantage of precise figures, we would face problems in our attempt to allocate a limited amount of funds. However, our current procedures for estimating revenues are so imprecise that the problem is becoming quite serious. The accounting impact of tax expenditures greatly resembles the accounting impact of entitlements. Just as we are unable to predict the level of annual funding that will be required to support entitlement programs, we are unable to predict with a high degree of accuracy the annual revenue loss resulting from tax expenditures. The more tax expenditures we enact, the greater the revenue mystery becomes.

Presently, there are 104 such tax provisions on the books accounting for a revenue loss of—depending on which of many equally valid Government guesses you use—approximately $266 billion. That figure has grown at an annual rate of 14 percent since 1975 when it was approximately $90 billion.

ESTIMATING REVENUE DOLLARS CRITICAL TO SUCCESS OF BUDGETARY PROCESS

Effectively estimating revenue dollars is critical to the success of the budgetary process. In an effort to address these inequities in the institutional treatment of subsidies by Congress. I have proposed amending the Budget Act through S. 193. This bill would improve the ability of Congress to exercise oversight over tax spending. Additionally, the measure would provide a budgetary restraint on the proliferation of new tax expenditures.

S. 193 would, first, set a statutory limitation on the total amount of revenue loss from tax expenditures. Such revenue loss could not exceed 30 percent of net revenues collected in any fiscal year.

Second, the bill would provide authorization procedures for enactment of new tax expenditures. The congressional committees with legislative jurisdiction over the activity subsidized by the given tax expenditures would be required to authorize its enactment.

Finally, S. 193 requires sequential referral of any legislation authorizing new tax expenditures to the Budget Committees of the Congress.

Taken in total, S. 193 represents a modest but realistic attempt to take the first step in asserting budgetary control over tax expenditures. I am optimistic that this committee will take the lead in that effort. I am sure the testimony we will receive today will be of great value to us in our search for legislative solutions.

Senator Metzenbaum, do you have any comments?

Senator METZENBAUM. I do.

OPENING STATEMENT OF SENATOR METZENBAUM

Let me first commend the chairman for scheduling this hearing and for his comments which had been made at an earlier point relative to his concern on the issue of tax expenditures. It is a subject to which I have addressed myself time and time again at the Budget Committee because it didn't make sense to me to be cutting efficient programs, cutting senior citizens entitlement programs, cutting food stamp programs, and cutting anyone of a host of areas, while at the same time providing more and more tax loopholes because in the last analysis, many of the tax expenditures are nothing more than tax loopholes, although it wouldn't be fair to generalize all of them fit into that category.

Now, it is a fact on the previous occasion, when David Stockman was before this committee, and I raised the question with him at that time as to whether or not he had not discussed the issue at the White House; he did indicate that he had done so. And then when I pressed him and asked him whether he would tell us what he had discussed and which ones he had recommended, he indicated he would be inclined to respond in that matter.

TAX LOOPHOLES DISCUSSED

I then ticked off for him a list of specific tax expenditures which I considered to be tax loopholes, and asked him whether or not he had discussed those on a one-by-one basis. And he responded in the affirmative, yes-yes, indeed, he had.

I asked him if there were any I had missed, and he said, "No, as a matter of fact, I had not."

I noticed in his article in the Atlantic Monthly, he indicated that he had indeed proposed this whole area of moving forward to eliminate tax loopholes, and that his proposals had been vetoed in its most controversial elements.

When Mr. Regan was before us, the Secretary of the Treasury, I asked him at that time about the question of tax shelters.

Mr. Regan told me last April, our committee, that shelters would not be needed because of the lower rates in investment incentives in the new tax bill. To this, I questioned him because I indicated to

him then, as I indicate now, that I know very few people who want to pay any taxes.

The Wall Street Journal interview of Mr. Regan on October 19, 1981, said:

> When it is seen in its full flower, I think business will realize that it has such an enormous tax break in many of the so-called loopholes and the type of thing they will no longer need.

And we met subsequently, and by that time the Business Week article had been published, and also on October 19, which said:

> Far from snuffing out the tax shelter industry as much as expected, the new tax law, if anything, gives the shelter a hefty booster shot.

I believe, Mr. Chairman, that the Senator from Kansas is to be commended for her having proposed this legislation because it moves us in the right direction.

It, at least, makes the issue. It will perhaps help us to get some response from the White House because when Mr. David Stockman was before us on October 1, I inquired of him at that time as follows:

> Why not zero in on some of these areas where there are special tax privileges that certain people or certain corporations have as a benefit instead of again trying to cut back on aid to education or trying to cut back on food stamps or the programs that have to do with people. Why do you not move in this direction?
>
> Mr. STOCKMAN. Senator, let me give you two answers. One, I think that we have suggested we are going to examine many of those features that you mentioned. We have even expressly said in the case of ADB's, changes need to be made. We will propose. I assume the Congress will dispose, and there will be a rather strenuous and lively debate about the policy wisdom of any of these changes.
>
> Senator METZENBAUM. When?
>
> Mr. STOCKMAN. We expect to have our set of detailed legislative proposals to the Hill in a matter of a couple of weeks.

That was October 7, 1981. We still have not heard from the White House.

MORE LOOPHOLES TODAY BECAUSE OF RECENT TAX LAW

We have, of course, read the Atlantic Monthly article, and we know what that is about. But the fact is, what we are talking about today, what the Senator from Kansas has made possible for us to talk about, is the fact that there exist today more loopholes, a greater number of loopholes than we ever had in the tax bill before by reason of the recent tax law, and the whole concept of one company selling its tax losses to another company, and the only one that gets hurt on that basis is the Treasury.

That will cost something in the area of $50 billion in the next 5 years. That is the most absurd proposal that I think could possibly have been considered and I am frank to say that I think very few of us in the Congress knew it was in the bill when it was enacted on the floor of the Senate.

But there are so many other tax breaks that we continue to give. The oil industry tax breaks in 1981 tax bill, special provisions for royalty owners which have some justification, special provisions for the strippers which has some justification, special provisions for new oil, maybe you can make an argument, but all of the other provisions that the oil companies have been getting over a period

of years, we do nothing at all about that, but we provide new loopholes in the last bill.

The provision that oil companies get special treatment with respect to their intangible drilling costs is totally contrary to any other corporation in America, making it possible for oil companies to write off in the first year in intangible drilling costs for no other segment of the American economy is given the privilege of writing off their capital expenditures in the first year.

The oil and gas depletion allowance which amounts to billions of dollars a year, there is no reason for its existence, continuation in our law.

We have, I believe, that if we targeted industrial revenue bonds, we believe we can use industrial revenue bonds, but they ought to be limited in the last bill that we had.

The other evening on the joint resolution, there was some effort made along that line.

ELIMINATE SOME OF THE ABUSES IN TAX LAW

The fact that financial institutions, banks, can write off all of their bad debt losses over and above a certain percentage just doesn't make sense. No other business is given that privilege, but we permit the banks to do that just because they had able lobbyists representing them in the past, in the foreign tax credit on oil and gas extraction, and so many others as well.

Mr. Chairman, this is a problem that gnaws at the guts of our tax measure. This is a problem that really is such a major concern as far as our being able to balance the budget, and while we are out there fighting about $2 billion or $4 billion or $6 billion, as to whether or not they should or should not veto, the President should or should not veto the bill, and whether or not some item ought to be in or not be in, that perhaps has to do with the quality of life of an American, we do nothing at all about eliminating some of the most egregious areas in the tax bill, and I am pleased to see that you are moving in this direction, and hope that this is just the beginning of a rather strong, rapid movement.

I think this is a way we can help to balance the budget. As the chairman knows, I submitted a list at our last Budget Committee hearing that would have made it possible to balance the budget without any further budget cuts, merely by eliminating some of the abuses that exist in law at the present time.

I thank the chairman, and I commend the Senator from Kansas.

Senator KASSEBAUM. Senator Gorton?

OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. I, too, should like to thank you for holding this hearing and express my admiration to Senator Kassebaum for introducing a bill on so significant a subject. I am particularly interested as we go through this hearing and this process dealing to a certain extent with individual tax preferences. The materials we have on which this hearing is based indicate that there is some 107 such provisions. Some of them, as the Senator from Ohio has said, are probably in there for no better reason that they had an extremely effective lobby.

Many of the others are in the tax code because it was perceived or hoped such sections would have a positive economic effect by diverting investment into a more constructive way, for a number of really valid social goals such as encouraging individual homeownership.

KNOW WHAT EACH TAX PREFERENCE IS

It seems to me, however, that what we need to learn from this hearing and in the future is exactly what the cost of each of those tax preferences is, exactly what its intended goal was in changing investment or savings patterns in the society at the time in which it was originally passed, and exactly the extent to which we can know precisely what effect it has had in practice, with respect to many other preferences that have been part of the code for a long period of time, so that we can weigh the cost of each individual preference against the goal which it is designed to reach.

I suspect that if we are able to get that kind of information, we will all agree there are a number of these preferences which do serve a good social goal, a better social goal than simply repealing the preference or spending the money or lowering the marginal tax rate.

I am absolutely convinced, along with the Senator from Ohio, that we will find the cost of most tax preferences exceeding their worth to the society as a whole. The ability to deal with each one of them on its own merits as objectively as we possibly can and to perhaps set up a series of rules, something like those provided for by this bill for making these determinations automatically in the future seems to me to be very important.

Senator KASSEBAUM. Thank you very much, Senator.

MEETING IS JUSTIFIED

I think we ought to make it clear for purposes of other committees and some in particular, that we are justified in holding this meeting because of your bill which prescribes an amendment to the Budget Act, but in addition, the language which I read with reference to our jurisdiction would clearly permit us to do precisely what Senator Gorton has done, it would be at that point it would be by way of a report, and I would hope that we will find time, Senator Metzenbaum, after the hearing on this bill, to arrive at a premise upon which we might conduct further inquiry even if we are not going to have the Budget Act amended quickly, as prescribed by Senator Metzenbaum.

We certainly could furnish the service.

Senator METZENBAUM. Senator Kassebaum.

Senator KASSEBAUM. I don't mind the names being confused; it is a voting record that I worry about.

Senator METZENBAUM. I would like to be confused with your charm.

Senator DOMENICI. I don't know what I want to do about Senator DeConcini. He was accused of being the father of all my children the other night.

Let me make this one point, and then I will yield.

MAKE TAX LAWS SIMPLE AND EQUITABLE

If we were capable of moving the tax laws in two directions, we would be performing an admirable service for the American people. There is no greater yearning among the average American that we simplify the tax laws of this country and, second, make them more equitable. If we moved in that direction, even though it is not our primary function, and if that started here today, I believe we would have accomplished a great service for the American people.

You know, I want to say this to Senator Kennedy; we started discussing tax expenditures as part of our last resolution. And so the lists started showing up, not that we have new jurisdiction to rule any out or any in. In order to know what we are talking about, we had our staff tell us what some of them were. They barely got out the door when the poor Senate Budget Committee staff started getting phone calls. I have discovered a new rule with reference to tax expenditures. The lobbying effort on behalf of tax expenditures is directly and proportionately related to the justification for getting rid of them.

Some little hidden ones that no one heard of for $1½ billion immediately caused telephones to ring off the hook. If you use my rule of thumb, whether to continue a loophole or not, and you would conclude not. The lobbying is directly in proportion to the justification for getting rid of it.

Now, with that, Senator, I am going to leave and you can chair the committee, and I thank you again for your bill and for asking that we hold these meetings.

Senator KASSEBAUM. Thank you, Mr. Chairman.

Senator Moynihan, do you have anything to say?

Senator MOYNIHAN. No.

Senator KASSEBAUM. It is a pleasure to welcome as our first witness someone who has been very interested in this issue for sometime, and I greatly appreciated his comments at the time that I introduced this bill, and his continuing interest in it.

Welcome, Senator Kennedy. We will be interested in your observations.

STATEMENT OF EDWARD M. KENNEDY, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator KENNEDY. Thank you very much, Madam Chairman.

First of all, I want to express my appreciation to you and the Budget Committee and Senator Domenici, for holding these hearings on this important public policy matter.

Madam Chairman, you published an outstanding article earlier this year, April 15, in the Washington Star, addressing the issue of tax spending in a responsible way. You awakened the Senate to the responsibility to consider this issue. I commend you, for your leadership and for the very positive response that you have received from your colleagues on the Budget Committee. I pledge my own cooperation and support in these efforts.

Madam Chairman, I ask consent that a copy of your article may be printed at this point in the record.

[From the Washington Star, Apr. 15, 1981]

PLUGGING THE "TAX EXPENDITURE" DRAIN

(By Nancy L. Kassebaum)

Today's tax day. It's the day when Justice Oliver Wendell Holmes' words ("Taxes are the price we pay for civilized society") are to ring truest. You probably feel civilization has just cost you a 10 percent down payment on your soul.

It's not the best time to bring up the subject of tax expenditures. But if you are rattled by the amount of your tax payment, and if you pin the blame on government spending and inflation, then tax expenditures are part of the problem.

On Schedule A of your Form 1040 there were a few lines that made you feel better. They represented money being kept, not sent to Uncle Sam. Lines 1-10 claimed deductions for medical and dental expenses. Lines 11-16 claimed deductions for state and local taxes, real estate taxes, property taxes, etc. For all of us combined, Line 17 was worth about $20 billion in deductions for interest payments on our homes. Line 18 cost about $5 billion for those interest charges we paid for our credit and charge card spending.

CORPORATIONS NOT FORGOTTEN

These are exemptions for the individual. We all know that corporations have not been left in the cold. They will claim a huge amount in exemptions this year, i.e., expense account deductions, equipment deductions, etc. And aren't corporations also the beneficiaries of most deductions for individuals? (Banks and construction companies are big fans of the home mortgage deduction.)

Tax expenditures. Deductions. Loopholes. Incentives. Tax breaks. Depending on your perspective, and you tax return, these are the names given to provisions in the tax code that will "cost" the Treasury an amount equivalent to the defense budget. Something over $200 billion. Nobody is certain of the exact figure.

That's the rub. No one is certain. There will be no congressional oversight. No hearings. No authorizations. No control.

There are 92 tax expenditure provisions in the tax code. Admittedly, some have greater economic and social value than others. Most of these listed above serve a valuable purpose. But we must understand that what benefits us each as individuals has a massive cumulative effect.

From my vantage point on the Senate Budget Committee, I have spied no encouraging signals on the tax expenditure front. The aggregate revenue loss from these provisions has grown at a rate of 14 per cent annually since 1975. Over 25 per cent of revenue authorized to be collected *slips through* those legal loopholes. Without a glance, we forego $1 for every $3 we collect.

TAKING CHARGE

If these federal subsidies are ever to be brought within even the loose control of the budget process, we must do something. There are three steps we could take to restore a modicum of accountability to these "negative spending" provisions:

First, place a statutory limit on the amount of revenue loss from tax expenditures at a figure not to exceed 30 per cent of net revenues collected. The 30 per cent figure is approximately the level of present tax subsidies. At least, we can avoid next year's 14 per cent tax expenditure increase.

Second, require that any legislation providing a new tax expenditure be authorized by the congressional committee having jurisdiction over the subject matter addressed by the new proposal. At present, the committees with responsibility for programs supported through tax expenditures neither authorize nor oversee their effectiveness. Once enacted, most tax breaks outlive Methuselah, regardless of their tendency to advance or obstruct the public good.

Third, new proposals should be formally examined by the Senate and House Budget Committees before being sent to their respective bodies.

What these three proposals argue is for control . . . for the dicipline needed to bring the complete federal spending equation into full public view. If a particular need is important enough to merit an exemption, then the exemption will stand the test of a yearly budgetary review.

RUNNING AWAY FROM US

A report by the Joint Committee on Taxation estimates that by 1986 tax expenditures will have doubled to $465.3 billion from $228 billion in 1981. This is a 104 per

cent increase. Is it likely that we will find that much more dispensable in the budget to compensate for this revenue loss? Can we really expect the budget ever to be balanced under these conditions? Aren't we leaning a bit heavily on the expected windfall of supply side economics?

When 70–75 per cent of our budget is given a reprieve from Mr. Stockman's ax and the remaining 30 per cent has been cut to the bone. When the administration in addition plans for tax cuts over three years of almost $200 billion; when the administration and the Republican Party wager their political capital on a balanced budget; what's going to give?

We all like our tax deductions. But it is time we recognize this spending for what it is and take action to keep things from getting worse.

BILLIONS IN TAX SPENDING ESCAPE REVIEW

Senator KENNEDY. Madam Chairman, I welcome these hearings as an important bipartisan signal that the Senate may at long last be prepared to deal with one of the most embarrassing defaults in the budget process—the lax procedures by which hundreds of billions of dollars in tax spending escape any serious congressional review.

The painful experience on the continuing resolution demonstrates more clearly than ever before that at this time of drastic budget cuts, there can be no sacred cows. As a basic principle of fairness, we can no longer exempt tax spending or any other form of Federal spending from the budget process.

David Stockman understood this point as well as anyone. His famous "Chapter II" called for budget savings through reductions in tax expenditures. But his proposals were not sent to the Capitol because the President vetoed it.

Mr. Stockman thought Chapter II would provide increased revenues and thus reduce the huge deficit over the next 3 years. It would offset complaints about cuts in social welfare, because cuts in tax expenditures would primarily affect special interests groups.

"We have a gap which we couldn't fill even with all these budget cuts, too big a deficit," Stockman said. He indicated that his recommendations would have meant a $20 billion reduction in the deficit.

Madam Chairman, I ask consent that a brief excerpt from the current issue of The Atlantic Monthly may be printed in the hearing record at this point.

[From the Atlantic Monthly, December 1981, pp. 35–36.]

THE EDUCATION OF DAVID STOCKMAN

Long before President Reagan's speech to Congress, most of the painful details of the $41.4 billion in proposed reductions were already known to Capitol Hill and the public. In early February, preparing the political ground, Stockman started delivering his "black book" to Republican leaders and committee chairmen. He knew that once the information was circulating on the Hill, it would soon be available to the news media, and he was not at all upset by the daily storm of headlines revealing the dimensions of what lay ahead. The news conveyed, in its drama and quantity of detail, the appropriate political message: President Reagan would not be proposing business as usual. The President had in mind what Stockman saw as "fiscal revolution."

But it was not generally understood that the new budget director had already lost a major component of his revolution—another set of proposals, which he called "Chapter II," that was not sent to Capitol Hill because the President had vetoed its most controversial elements.

Stockman had thought "Chapter II" would help him on two fronts: it would provide substantially increased revenues and thus help reduce the huge deficits of the next three years; but it would also mollify liberal critics complaining about the

cuts in social welfare, because it was aimed primarily at tax expenditures (popularly known as "loopholes") benefiting oil and other business interests. "We have a gap which we couldn't fill even with all these budget cuts, too big a deficit," Stockman explained. "Chapter II comes out totally on the opposite of the equity question. That was part of my strategy to force acquiescence at the last minute into a lot of things you'd never see a Republican administration propose. I had a meeting this morning at the White House. The President wasn't involved, but all the other key senior people were. We brought a program of additional tax savings that don't touch any social programs. But they touch tax expenditures." Stockman hesitated to discuss details, for the package was politically sensitive, but it included elimination of the oil-depletion allowance; an attack on tax-exempt industrial-development bonds; user fees for owners of private airplanes and barges; a potential ceiling on home-mortgage deductions (which Stockman called a "mansion cap," since it would affect only the wealthy); some defense reductions; and other items, ten in all. Total additional savings: somewhere in the neighborhood of $20 billion. Stockman was proud of "Chapter II" and also very nervous about it, because, while liberal Democrats might applaud the closing of "loopholes" that they had attacked for years, powerful lobbies—in Congress and business—would mobilize against it.

Did President Reagan approve? "If there's a consensus on it, he's not going to buck it, probably."

Two weeks later, Stockman cheerfully explained that the President had rejected his "tax-expenditures" savings. The "Chapter II" issues had seemed crucial to Stockman when he was preparing them, but he dismissed them as inconsequential now that he had lost. "Those were more like ornaments I was thinking of on the tax side," he insisted. "I call them equity ornaments. They're not really too good. They're not essential to the economics of the thing."

The President was willing to propose user fees for aircraft, private boats, and barges, but turned down the proposal to eliminate the oil-depletion allowance. "The President has a very clear philosophy," Stockman explained. "A lot of people criticize him for being short on the details, but he knows when something's wrong. He just jumped all over my tax proposals."

Senator KENNEDY. Let me note here, Madam Chairman, that if the Kassebaum bill had been in effect for this year, we would have saved approximately $70 billion or over three times what Mr. Stockman was proposing.

Mr. Stockman fought and lost that battle within the administration, just as he fought and lost so many other battles for a fairer and more responsible budget policy. And on this issue, as on so many other issues, David Stockman was right.

Madam Chairman, I understand there has been some uncertainty whether Mr. Ture from the Treasury will be here to testify. I gather he is having some trouble clearing his testimony through OMB, so it will be interesting to see what his testimony will be, given Mr. Stockman's own proclivities on this question.

BIGGEST TAX LOOPHOLE IS BUDGET LOOPHOLE

There is no mystery about tax spending. Once the complex jargon of the Internal Revenue Code is stripped away, tax subsidies stand exposed for what they are—simply another way of spending Federal dollars. Other forms of Federal spending receive intensive scrutiny under the budget reform procedures established by Congress and the executive branch in recent years. Only tax spending is exempt. The biggest tax loophole of all is this budget loophole—the loophole that allows all the other loopholes to exist.

At a time when austerity in Federal spending is being pressed to the point of cruelty, it is wrong to demand budget cuts only in direct spending programs, while ignoring all the spending programs in the tax laws.

The Internal Revenue Code now contains 104 separate tax spending programs. These programs are found in all of the budget categories into which direct spending programs are divided—in some cases, the dollar amount of tax spending is equal to, or exceeds, the amount for direct spending programs in the same budget function.

Nothing turns on whether a budget dollar is spent as a tax subsidy or another form of subsidy. We know that any Federal spending program can be structured either as a direct spending program or as a tax spending program, as demonstrated by the current debate over tuition tax credits versus direct student grants as a means of providing increased Federal aid for education.

Madam Chairman, I have brought a chart that reflects the dramatic increase in the direct spending and tax spending that we have seen over the past decade. Direct spending has climbed from $232 billion to $709 billion, a 206-percent increase in the 10-year period.

In that same period, tax spending rose from $59 billion to $266 billion, a 345-percent increase.

Madam Chairman, I ask that a copy of the chart may be printed at this point in the record.

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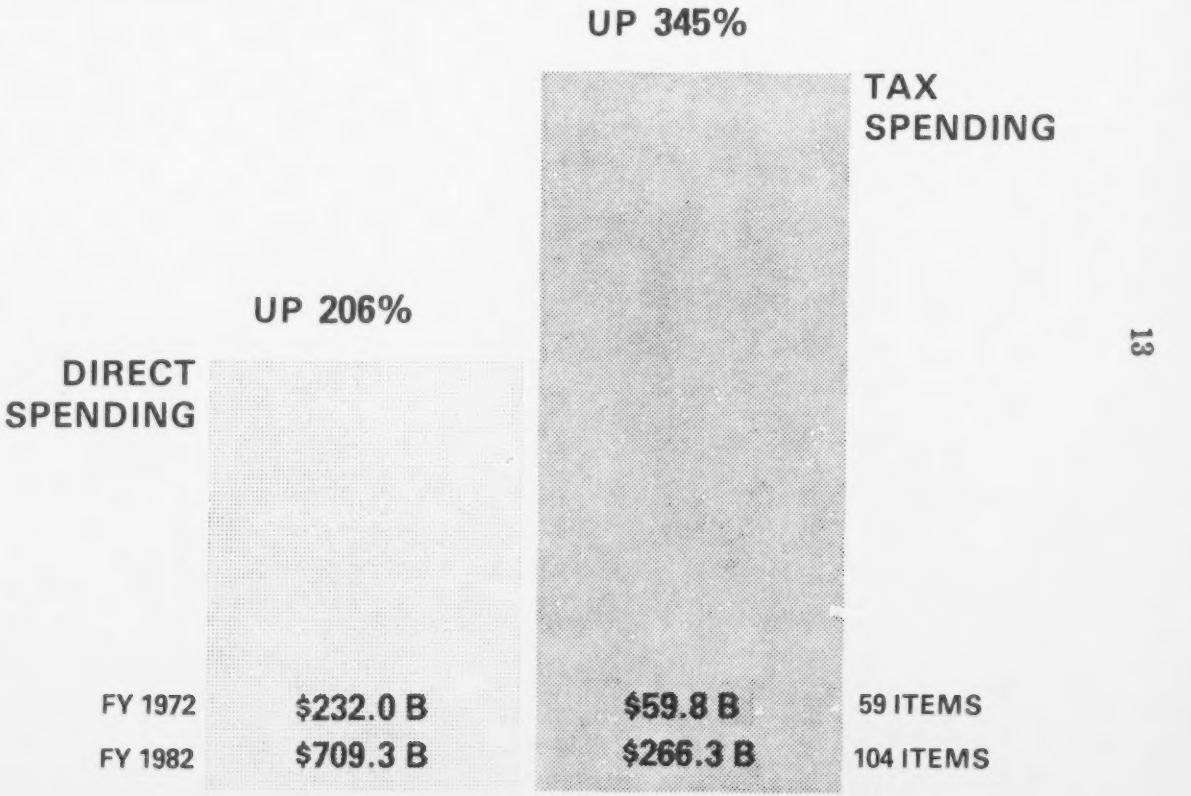
GROWTH OF FEDERAL SPENDING



Senator KENNEDY. In principle, it would be appropriate as a matter of budget policy to allocate any necessary reductions in spending in the ratio of about 3 to 1 between direct spending programs, and tax spending programs, since that is the ratio they bear to each other in the budget.

I would favor a principle of proportionality in budget cuts. If, for example, it is necessary to reduce spending by $40 billion from baseline levels to reach the desired targets for fiscal restraint and the budget deficit, the reduction could be achieved through cuts of $30 billion in direct spending, and $10 billion in tax spending. Yet, so far this year, virtually all the budget cuts are being made from direct spending programs, and almost none from tax spending programs.

THREAT OF CUTS IN TAX EXPENDITURES BRINGS LOUDEST CRYS

I have said that there are few real economic differences between tax spending and direct spending. But in fact, the most obvious difference is the intensity of the protest that goes up when a tax expenditure is threatened.

It has been said that no one fears more for the future of the country than a taxpayer about to lose a loophole. Millions of average Americans are now feeling the harsh impact of the present round of budget cuts in areas such as health, education, housing, jobs, nutrition, and fuel assistance. They suffer in apparent silence, because their voices go unheard and their pleas go unheeded here in the Halls of Congress.

But let Congress barely scratch a tax subsidy, and you might think the biggest oil companies, the wealthiest financial institutions, and the fanciest private restaurants were suddenly bleeding to death.

Nothing could be further from the truth. I believe that several billions of dollars can be saved by eliminating the fraud, fat, waste, abuse, and outright injustice that permeates our tax laws.

Part of the blame for the current waste and confusion lies in the archaic rules of congressional jurisdiction over direct spending and tax spending. The tax writing committees on the one hand and the authorizing and appropriating committees on the other hand, essentially go their separate ways, ignoring each other's actions and the obvious overlap in their spending roles.

TAX EXPENDITURES ANALOGOUS TO PERMANENT APPROPRIATIONS

In many respects, tax expenditures are analogous to permanent appropriations or entitlements, which are also especially troublesome aspects of the budget process, because they short circuit the two-step authorization-appropriation procedure by which Congress most effectively oversees many forms of direct spending.

The refundable earned income tax credit illustrates this procedural dilemma. The Labor Committee has jurisdiction over most job subsidy programs. But two other committees share jurisdiction over separate parts of this tax credit for low income workers—the Finance Committee has jurisdiction over the nonrefundable portion of the credit, and the Appropriations Committee has jurisdiction over the refundable portion, which is regarded as an outlay.

One unfortunate result of this divided jurisdiction has been to limit the use of refundable tax benefits, since the committee responsibilities are not coordinated. Yet refundability is an effective device to avoid both the inefficiency and the injustice that otherwise exist in the availability of tax subsidies.

In the recent tax bill, the Congress chose to avoid this inefficiency and injustice by creating the controversial leasing rules that, in effect, enable corporations to buy and sell tax deductions and tax credits. Refundability would have been a more logical way to achieve the goal of the leasing section, and it would have avoided the recent abuses of many leasing schemes—but our jurisdictional rules blocked that solution.

The current sorry state of congressional control over tax spending is more the result of historical accident than logic or intent. The relatively recent recognition of the reality that large numbers of provisions in the Internal Revenue Code are actually spending programs has meant that the traditional congressional review procedures are seldom, if ever, applied to tax spending.

CHANGE IS ON THE WAY IN TAX SPENDING

But change is on the way, as these hearings suggest. I commend you, Senator Kassebaum, for the far-reaching legislation you have proposed to reduce the jurisdictional overlaps in Congress and to place a realistic ceiling on tax spending. In past Congresses, I have introduced proposals for reform in this area, and I continue to believe that discipline of this sort is essential if the budget process is to function the way it should. And Common Cause, in its own excellent and farreaching studies of tax spending in 1978 and 1981, has also concluded that such reforms are essential.

At a minimum, I believe that we should enact reforms to achieve the following goals:

Regular congressional review of tax spending programs.

Close coordination between the review of tax spending programs and the review of direct outlays in the same budget category.

An opportunity to eliminate outmoded and inefficient tax spending programs.

Finally, just as Congress must put its own house in order, so the administration must upgrade its own budget procedures to achieve more effective coordination between tax spending and direct spending. In particular, I commend the example of Canada, which uses a so-called "envelope system" of expenditure management to prepare the annual government budget. Under this system, overall budget targets are set for each policy area, and the targets include both direct spending and tax spending. As one form of expenditure goes up, the other must go down in order to stay within the budget envelope.

Until now, we have enjoyed the luxury of both guns and butter in the tax laws. Now the budget process is teaching us that the same sort of choices must be faced in spending through the Internal Revenue Code that we are already making in appropriations for goals like homes and schools and jobs and health and national defense.

Madam Chairman, I ask consent to insert a brief description of the Canadian envelope system in the record at this point. The description is an excerpt from a Canadian budget document comparable to Special Analysis G of the U.S. Budget.

[A brief memo on the Canadian envelope system follows:]

[Excerpt from the Government of Canada Tax Expenditure Account, December 1980]

III. Tax Expenditures and the Envelope System

Under the previous fiscal management system, tax expenditures had no direct impact on budgetary allocations, either in aggregate or at the level of individual programs. While the initial direct expenditure targets did take into account the government's overall fiscal position, as well as incentives provided through the tax system, any subsequent introduction or modification of tax expenditure provisions during the year did not generally trigger a corresponding adjustment in the initial direct expenditure targets. This system was anomalous in that tax expenditures are in many ways no different than direct budgetary outlays. Both have the effect of increasing the government deficit and of increasing the support provided to a given policy area. However, because tax expenditures did not directly influence budgetary allocations, incentives existed for departments and ministers responsible for individual policy areas to put greater emphasis on providing incentives through the tax system. Tax expenditures could thus be used as an indirect method of increasing the funds made available to particular policy areas.

The government of Canada has now adopted a new expenditure management system. This system involves setting targets for total government outlays and for outlays in each broad policy area such as economic development, social development, and foreign policy and defence. Funds allocated to these broad policy areas are referred to as expenditure envelopes. Allocation of funds within an envelope is determined primarily by a committee comprised of ministers responsbile for programs in the policy area.

This new expenditure management system has removed the anomaly that previously existed with respect to tax expeditures. Under the new system, the revenue cost of any changes in tax expenditures proposed by program ministers will reduce the envelope allocation for that particular policy area. The fiscal discipline implied by the initial envelope allocations can no longer be avoided through the use of tax incentives. While program ministers can make proposals for changes in tax expenditures, their introduction is subject to concurrence of the Minister of Finance, who continues to have overall responsibility for the tax system. It is expected that the new system will lead to better appreciation of incentives provided through the tax system, and a fuller consideration of their fiscal implications in the expenditure planning process.

Senator Kennedy. Madam Chairman, as your important bill and the Canadian example demonstrate there are ways to deal with tax spending as part of the budget process. It is time to end the budget anomaly that for too long has permitted uncontrolled spending through the tax laws. I stand ready to work with all the members of this committee, the Finance Committee, and the Appropriations Committee, to achieve this goal.

Thank you.

Senator Kassebaum. Thank you, Senator Kennedy.

PREPARED STATEMENT OF SENATOR EDWARD M. KENNEDY, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

I welcome these hearings as an important bipartisan signal that the Senate may at long last be prepared to deal with one of the most embarrassing defaults in the budget process -- the lax procedures by which hundreds of billions of dollars in tax spending escape any serious Congressional review.

The painful experience on the continuing resolution demonstrates more clearly than ever before that at this time of drastic budget cuts, there can be no sacred cows. As a basic principle of fairness, we can no longer exempt tax spending or any other form of federal spending from the budget process.

David Stockman understood this point as well as anyone. His famous "Chapter II" called for budget savings through reductions in tax expenditures. He fought and lost that battle within the Administration, just as he fought and lost so many other battles for a fairer and more responsible budget policy. And on this issue, as on so many other issues, David Stockman was right.

There is no mystery about tax spending. Once the complex jargon of the Internal Revenue Code is stripped away, tax subsidies stand exposed for what they are -- simply another way of spending federal dollars. Yet other forms of federal spending receive intensive scrutiny under the budget reform procedures established by Congress and the Executive Branch in recent years. Only tax spending is exempt. The biggest tax loophole of all is this budget loophole -- the loophole that allows all the other loopholes to exist.

At a time when austerity in federal spending is being pressed to the point of cruelty, it is wrong to demand budget cuts only in direct spending programs, while ignoring all the spending programs in the tax laws.

The Internal Revenue Code now contains 104 separate tax spending programs. These programs are found in all of the budget categories into which direct spending programs are divided -- in some cases, the dollar amount of tax spending is equal to, or exceeds, the amount for direct spending programs in the same budget function.

Nothing turns on whether a budget dollar is spent as a tax subsidy or another form of subsidy. We know that any federal spending program can be structured either as a direct spending program or as a tax spending program, as demonstrated by the current debate over tuition tax credits and direct student grants as a means of providing increased federal aid for education.

Inevitably, if tax spending is exempted from the strict scrutiny given other federal spending, or if the scrutiny is perceived to be less rigorous, then pressures will escalate in Congress to bypass the budget process through enactment of new tax expenditures designed to avoid the curbs imposed on other forms of spending.

In recent years, spending through the tax laws has risen even more rapidly than direct spending. From 1972 to 1982, direct spending increased by 206 percent, whereas tax spending increased by 345 percent. The increase in tax spending has been especially dramatic in recent

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years, when, as a result of major new tax subsidy legislation, tax spending often grew twice as fast as direct spending. If Congress is concerned about runaway federal spending, it obviously has to be concerned about these rapid recent increases in spending through the tax laws.

Direct federal spending will total about $700 billion in fiscal year 1982. Tax spending will total about $270 billion, or more than one-third the amount of direct spending.

In principle, it would be appropriate, as a matter of budget policy, to allocate any necessary reductions in spending in the ratio of approximately 3-to-1 between direct spending programs and tax spending programs, since that is the ratio they bear to each other in the budget.

I would favor a principle of proportionality in budget cuts. If, for example, it is necessary to reduce spending by $40 billion from baseline levels to reach the desired targets for fiscal restraint and the budget deficit, the reduction could be achieved through cuts of $30 billion in direct spending, and $10 billion in tax spending. Yet so far this year, virtually all the budget cuts are being made from direct spending programs, and almost none from tax spending programs.

I have said that there are few real economic differences between tax spending and direct spending. But in fact, the most obvious difference is the intensity of the protest that goes up when a tax expenditure is threatened.

It has been said that no one fears more for the future of the country than a taxpayer about to lose a loophole. Millions of average Americans are now feeling the harsh impact of the present round of budget cuts in areas such as health, education, housing, jobs, nutrition and fuel assistance. They suffer in apparent silence, because their voices go unheard and their pleas go unheeded here in the halls of Congress.

But let Congress barely scratch a tax subsidy, and you might think the biggest oil companies, the wealthiest financial institutions, and the fanciest private restaurants were suddenly bleeding to death.

Nothing could be farther from the truth. I believe that several billions of dollars can be saved by eliminating the fraud, fat, waste, abuse and outright injustice that permeates our tax laws.

If we want a new idea for the economy in the 1980's, we ought to start by cutting tax spending the same way we have cut other forms of federal spending. Let me cite just one example, a little removed from the controversy over the most notorious tax loopholes.

Throughout this year, we have been debating the level of spending for health care in the budget. In my view, many important programs are now bearing the brunt of unacceptable cuts, particularly in areas such as maternal and child health, immunization, and neighborhood health centers. I continue to hope that additional funds will be restored to these essential areas as the budget process goes on.

By contrast, the tax spending programs that subsidize health care remain untouched. In the current fiscal year, those subsidies will exceed $19 billion.

If we must have an austere budget on health, the question must be faced as to whether spending for health programs in the tax laws deserves a higher priority than the direct spending programs slated for drastic cuts.

My own view is that this country must eventually move forward to national health insurance, as the only realistic means of controlling costs and providing adequate health care to all our citizens.

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But until that goal is achieved, we must make the most efficient use of the federal funds currently available for health care. Paying 50% to 70% of the medical bills and private health insurance premiums of the highest income families in the country hardly represents a pressing health priority for the nation. At the very least, revenues from these tax spending programs should be shifted to health care programs that will serve more citizens more effectively.

Part of the blame for the current waste and confusion lies in the archaic rules of Congressional jurisdiction over direct spending and tax spending. The tax-writing committees on the one hand, and the authorizing and appropriating committees on the other hand, essentially go their separate ways, ignoring each other's actions and the obvious overlap in their spending roles.

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Until now, we have enjoyed the luxury of both guns and butter in the tax laws. Now the budget process is teaching us that the same sort of choices must be faced in spending through the Internal Revenue Code that we are already making in appropriations for goals like homes and schools and jobs and health and national defense.

As Senator Kassebaum's important bill and the Canadian example demonstrate, there are ways to deal with tax spending as part of the budget porcess. It is time to end the budget anomaly that for too long has permitted uncontrolled spending through the tax laws. I stand ready to work with all the members of this Committee, the Finance Committee, and the Appropriations Committee to achieve this goal.

* * *

GROWTH OF DIRECT SPENDING
AND TAX SPENDING 1972-1982

	DIRECT SPENDING		TAX SPENDING	
FISCAL YEAR	Amount ($ Billion)	Percent Increase	Amount ($ Billion)	Percent Increase
1972	232.0	9.7	59.8	15.7
1973	247.1	6.5	65.4	9.4
1974	269.6	9.1	82.0	25.4
1975	326.2	21.0	92.9	13.3
1976	366.4	12.3	97.4	4.8
1977	402.7	9.9	113.5	16.5
1978	450.8	11.9	123.5	8.8
1979	493.6	9.4	149.8	21.3
1980	579.6	17.4	181.5	21.2
1981	660.5	14.0	228.6	26.0
1982	709.3	7.4	266.3	16.4

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TAX TUITION CREDIT

Senator KASSEBAUM. I would like to ask you a question, as the ranking member of the Labor and Human Resources Committee. You cited an example in your opening statement regarding refundable tax credits and job subsidy programs. Tuition tax credits have also been much debated and will continue to receive serious consideration.

Such proposals would have a profound effect, I think, on education policies. As the ranking member of the Labor and Human Resources Committee, do you think it would be beneficial to have the opportunity in conjunction with the Finance Committee, to weigh out the impact on educational policy?

Senator KENNEDY. The answer is yes, as suggested by your legislation. For example, I have been opposed to the tuition tax credit. I have questions about its constitutionality. I have questions about its large revenue cost, in light of the cutbacks in other spending programs for education.

Giving the authorizing committees and the Appropriations Committee a limited period of time to review that proposal seems to me a wise policy.

And I would support that process and that procedure.

Senator KASSEBAUM. You feel the committee could make the determination, and a pretty fairly precise one, of the impact to educational dollars from dollars lost or gained as the case may be?

Senator KENNEDY. Yes. And I think that determination ought to be available to the Members of the Senate to consider when they are making a final judgment. Whether it is in education, or health, or energy, or transportation, or other areas of public policy, current or new spending programs should certainly be considered by the authorizing committee.

BUDGET HAS LITTLE OVERSIGHT

Senator KASSEBAUM. One of the aspects of the whole budget process which is a serious problem that is becoming increasingly apparent is how little oversight we have over much of the budget. I think this is true because of the recent growth of entitlement programs, contract authority, and borrowing authority. Only about 50 percent of all direct Federal spending is subject to annual appropriations.

In your committee, for instance, entitlement spending would be railroad pensions for retirement. Borrowing authority would include the guaranteed student loan program and contract authority would be technical assistance contracts for the operation of primary health care centers. All of these kinds of budget authority are part of the budget over which we really don't exercise direct control.

The lack of periodic review of these programs, when combined with the lack of such review for tax expenditures, means Congress is not exercising oversight over substantially more than half of all the programs it subsidizes. Obviously, we all share these concerns or we wouldn't be here today. I think you have spoken to the needs that you see, and yet I am sure none of us have wanted to add a

further burden of paperwork to the committee's load unless we felt we could really make it work.

Senator KENNEDY. There are two comments I would make. I think it is worthwhile to study the Canadian system, which takes into consideration both tax expenditures and direct appropriations. For example, we agree that support for homeownership is a desirable public policy for the United States. Then we must make a judgment—should we do encompass homeownership through the tax system, or should we do so through direct appropriations. Congress ought to make that judgment. We use both methods today, but there is no coordination between the two approaches.

The question is, are we doing it in the most efficient way, using both direct appropriations and tax spending?

We hear a great deal about the need for new answers to the problems we are facing in the eighties, different from the answers to the problems we had in the sixties.

One important new answer for today is to coordinate the important area of tax spending with other areas of public policy. We are not doing so at the present time.

Our review ought to be part of the budget process. The concept of tax spending has been recognized in the budget process since the beginning. It has been recognized by Republicans and Democrats alike.

But it has only been given lip service over the years. What you have here, and what I find most promising, is that the Budget Committee will put some life into this principle. It is a complicated and difficult issue, but you are giving it the attention it deserves.

Senator KASSEBAUM. Senator Moynihan?

Senator MOYNIHAN. Thank you.

I only want to thank Senator Kennedy who certainly has been at this longer than any of us present.

One perhaps could say that your time has come through certain unanticipated consequences of the present administration's policies. The Treasury is empty, and evidently there will be no rollback in the Economic Recovery Tax Act, which is so very back end loaded to produce enormous out year deficits. And so, it could have been predicted last summer that, by now, there would be a lot of flogging of Treasury Department officials to find tax expenditures that can help close the deficit.

POSSIBLE NEED FOR CREDIT BUDGET

I wonder if I can ask you if you don't think there is a comparable need for a credit budget.

Many credit activities can be considered analogous to a tax expenditure when the Federal Government guarantees loans of one kind or another, and in that way provides a subsidy to the ultimate recipients of the loans. Presumably, these loans wouldn't be offered in an open market at acceptable rates, so a quasi-closed market is developed. Surely, this can have as much effect on investment patterns as the revenue system itself.

Moreover, Federal credit subsidies are a form of expenditure, because the Federal Government must borrow ultimately to finance them.

Senator KENNEDY. I think it would be well worth considering.

Senator MOYNIHAN. When we consider Federal spending programs, Federal taxes, the taxes the Government chooses not to collect, or the credit it expends—if we think only of one—to the exclusion of the others, we will miss the total economic impact of Federal activity which the budget process should enable us to see.

Senator GORTON. One of the comments of Senator Moynihan leads me to this question.

As you pointed out, there has been a concern, at least in the abstract, over this process for a number of years. That concern does not seem to have translated itself into fewer tax expenditures or tax purposes, but only into more. It seems to me to be part of the thrust of your testimony that we are going to have to change the structure within which we deal with tax preferences and, of course, Senator Kassebaum's bill does that by putting a limit, artificial as it may be, on what can take place.

Your own 3-to-1 ratio of budget cuts to tax expenditure cuts is another one. May I say, incidentally, Senator, that in a number of respects that is a rather modest goal. The proposal which Senator Domenici originally made for a second budget resolution would have had a ratio much more heavily weighted toward reduction in tax expenditures than our own. By the same token, Senator Moynihan has pointed out this may be a matter of more moment now, simply because the Treasury is empty.

NO CHANGE NEEDED IN STRUCTURE TO REDUCE UNJUSTIFIED EXPENDITURES

Is it your feeling, simply by looking at a number of these 104 or 107, whatever the number is, tax expenditures during the course of the next 6 months or 1 year, we might succeed significantly in reducing the least justified of those expenditures without any change in structure at all, but simply because of a monetary need?

Senator KENNEDY. I think so, Senator.

We have a responsibility, on the direct spending side, to review the programs. The American people expect us to eliminate waste and inefficiency, whether it is in social programs or defense programs. We have the same responsibility on the tax-spending side.

We are doing a better job than we have done in the past in meeting that responsibility in the area of direct spending. But we are not meeting it at all in the area of tax spending.

Obviously this is a question that has to be worked out with the Finance Committee and the Appropriations Committee. But I think the device which Senator Kassebaum has proposed is a reasonable one. It will help us do the job we are trying to do more efficiently and more effectively, and at a good deal more savings.

Senator GORTON. Thank you, Senator.

Senator KASSEBAUM. Thank you, Senator.

Senator KENNEDY. Thank you very much.

Senator KASSEBAUM. Under Secretary Ture was to be here as a witness from the Treasury Department but is not able to be here today.

It is our pleasure now to welcome Dr. Rivlin——

Senator MOYNIHAN. Madam Chairman, could we ask why Mr. Ture is not here?

Is he ill?

Senator KASSEBAUM. Yes, it is my understanding that he is.

Senator MOYNIHAN. What ailment?

Senator KASSEBAUM. Probably financial.

No, I don't know, but he had planned to be here and called this morning and was not able to be here, and to my knowledge, there is no one else here from the administration who would be testifying at this point.

Senator MOYNIHAN. Madam Chairman, we have just had the administration's extraordinary assertion that the Congress can't seem to produce the budget or can only produce the wrong kind of budget, and we have vetoes. And here we are, working seriously on a subject of major consequence to that budget, and the administration will not even send an Under Secretary of the Treasury to comment on your legislation and on the ideas we all have for balancing the budget.

Today, we would like to direct our ideas to the special interests that enjoy tax loopholes. Now, is that something that the administration will not discuss—except off the record with Mr. Greider of the Atlantic Monthly?

Senator KASSEBAUM. They have been very interested——

Senator MOYNIHAN. I don't want to harass you, Madam Chairman. You wanted the Under Secretary to come, and you invited him.

Senator KASSEBAUM. They have been very interested.

Senator MOYNIHAN. Maybe they are terrified of you.

Senator KASSEBAUM. In the continuing resolution of the last few days, they have had their time taken up and haven't perhaps been able to——

Senator MOYNIHAN. The President has gone off for Thanksgiving.

Senator KASSEBAUM. He wasn't scheduled to testify, either.

Senator MOYNIHAN. Would you send Mr. Ture our regards, address a postcard or a get well greeting, that we might wish him a speedy recovery?

Senator KASSEBAUM. Dr. Rivlin, it is a pleasure to welcome you here today.

STATEMENT OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. RIVLIN. It is a great pleasure to be here.

I have with me James Verdier, who is our Assistant Director for Tax Analysis.

I appreciate this opportunity to testify on possible approaches to controlling tax expenditures. This is one of the important unresolved issues in the budget process, and I am pleased that Senator Kassebaum has taken the initiative to focus attention on it with her bill and with these hearings. In September of this year, the Congressional Budget Office [CBO] issued a report entitled "Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-1986," which contains extensive discussion of tax expenditures and the budget process. Copies of that report have been made available to this committee. My testimony this after-

noon is divided into three sections. The first discusses the importance of controlling tax expenditures, the second deals with possible alternative ways of controlling them, and the third focuses specifically on Senator Kassebaum's proposed "Tax Expenditure Limitation and Control Act" [S. 193].

THE IMPORTANCE OF CONTROLLING TAX EXPENDITURES

Tax expenditures have become one of the major ways in which the Federal Government allocates resources and affects private-sector decisions. The most recent tax expenditure budget, compiled last March, included 104 items totaling $266.3 billion. The Economic Recovery Tax Act of 1981 added 8 new tax expenditures, expanded 22 others, and reduced 2.

In many areas, the Federal Government exerts more influence through tax expenditures than it does through direct spending. The tax expenditures for energy are greater than direct Federal outlays, for example, and tax expenditures for housing exceed outlays by more than 4 to 1.

In 1967, the first year for which an official tax expenditure budget was compiled, there were 50 items with a total revenue loss of $36.6 billion—20.5 percent of total Federal direct outlays in that year and 4.4 percent of the gross national product [GNP]. By fiscal year 1981, tax expenditures had grown to a total of $228.6 billion—34.6 percent of outlays and 8 percent of GNP.

Tax expenditures add to the Federal deficit in the same way that direct spending programs do. They allocate resources and provide incentives and benefits in the same way that spending programs do. They are one of the ways the Federal Government plays a role in the economy and involves itself in the lives of its citizens.

But unlike direct spending programs, tax expenditures have low visibility in the budget process and are controlled only in a limited and indirect way. The Budget Act requires that a tax expenditure budget be compiled each year, but it is presented only for informational purposes. No direct budgetary decisions are based on it, and as a consequence, it receives relatively little attention. One consequence of this low visibility is that activities that may not have sufficient support to obtain Federal funding through direct outlays may be funded through the back door by tax expenditures.

Tax expenditures show up as revenue losses, and thus have an important effect on the revenue totals that are included in congressional budget resolutions. But they are treated for this purpose as simply another form of tax cut. They are not treated as alternatives to spending programs. There is an important distinction between general tax cuts that reduce taxes broadly across the board, and tax expenditures that provide a tax cut only to those in certain specified circumstances, or who act in certain specified ways. General tax cuts return resources to people to use in whatever way they see fit; tax expenditures return resources to people only if they do what the Government would like them to do, or if they are thought deserving of special help. The present treatment of tax expenditures in the budget process blurs this distinction.

ALTERNATIVE WAYS OF CONTROLLING TAX EXPENDITURES

Tax expenditures could be controlled in the same way direct outlays are. The Budget Committees and the Congress could vote on a tax expenditure budget, broken down into budget functions and subfunctions. Tax expenditures could be limited to specified amounts, and they could then be allocated to the committees with jurisdiction over them through a "crosswalk" procedure, as direct expenditures are. If they were all allocated solely to the tax committees, however, they would end up being treated in essentially the same way as they are now—as just another form of tax cut. Allocating tax expenditures jointly to the tax committees and to the committees with jurisdiction over analogous spending programs would be one way of emphasizing their relationship to spending programs. This procedure would be similar in some respects to the way spending is now allocated jointly to the Appropriations Committees and to the authorizing committees. Your bill contains a variant of this approach in its requirement that tax expenditures be approved by the Budget Committees and by the committees with authority over analogous spending programs.

Short of this, steps could be taken to increase the visibility of tax expenditures. The Budget Committees and the Congress could vote specifically on targets for tax expenditures, as they do now for loan programs in the credit budget. While nonbinding targets do not receive the same degree of visibility and attention as binding ceilings, this procedure would give tax expenditures more visibility than they now have. As more experience was gained with this approach, there could be gradual movement toward more binding limitations.

Actually, I think that is not a strong enough approach for the present situation.

Alternatively, tax expenditures could be subjected to even stricter limits than are imposed on spending programs. Following the approach of the various spending limitation bills and constitutional amendments that have been introduced in recent years, total tax expenditures could be limited to some fixed percentage of GNP, Federal outlays, total Federal receipts, individual and corporate income tax receipts, or some other measure.

Senator Kassebaum's bill, for example, would limit tax expenditures to 30 percent of total Federal revenues. The growth in tax expenditures might also be limited to a fixed percentage amount, or tied to inflation, GNP growth, or some other measure. The problem with approaches that seek to use a fixed formula is that no formula can automatically take into account all of the economic and political variables that are important in budget making. That, of course, is one of the attractions of fixed formula plans for those who do not believe that budgets should be affected by all of these variables, or who worry that the Congress will not reach the proper decisions if allowed to take these variables into account. The current budget process, by contrast, is designed to allow the Congress to take into account whatever factors it considers relevant in determining budget levels.

A further problem with imposing stricter budget controls on one type of Federal activity than on others is that a resource will tend

to flow toward the less controlled activity. The fact that both tax expenditures and loan programs have grown more rapidly in recent years than direct outlays is an illustration of this. Ideally, the budget process should treat all forms of resource allocation the same, so that decisions are based on the merits rather than on the type of budget control.

Let me summarize very briefly the next section which alludes to a very real problem—that is, the problem of estimating tax expenditures and particularly estimating an arithmetic total. It is more difficult to estimate tax expenditures than direct expenditures because they are not observed. They are the answer to the question, what taxes would be paid if the tax code were different. We have spelled this out more completely in the CBO document I mentioned earlier. There is a certain amount of uncertainty and controversy involved in the estimation of tax expenditures and particularly in the concept of adding them into a total, but let me skip over that and discuss specifically S. 193.

TAX EXPENDITURE LIMITATION AND CONTROL ACT (S. 193)

S. 193 seeks to control tax expenditures by making two major changes in the Budget Act:

First, budget resolutions would be out of order "if the level of revenue loss from tax expenditures contained in the resolution exceeds 30 percent of the recommended level for net revenue set forth in such resolution."

Second, new tax expenditures, or modifications of existing tax expenditures, would have to be approved by the committees having jurisdiction over the activity that the tax expenditure affects, and by the Budget Committees, as well as by the tax committees. New or modified tax expenditures would also have to be reported by the May 15 deadline that applies to spending authorizations.

The second of these changes could lead to major improvements in the way tax expenditures are dealt with in the budget process. Before discussing this, however, I would like to talk briefly about the first part of the proposal.

LIMITING TAX EXPENDITURES TO 30 PERCENT OF TOTAL REVENUES

As my testimony so far has indicated, any limit on the total amount of tax expenditures must confront the fact that the total itself is a somewhat artificial number. In addition, as discussed earlier, limiting tax expenditures by the use of a fixed formula would impose on them a discipline that is more strict and rigid than that which now applies to spending programs. The better approach is probably to try, insofar as possible, to subject all forms of resource allocation to the same kind of budget control.

There are also some special problems in tying tax expenditures to total revenues rather than to some more general measure, such as the gross national product. Increases in excise taxes or a windfall profit tax on decontrolled natural gas would increase overall revenues, and thus permit an increase in tax expenditures—whether or not this was the desired result. An increase in income tax rates or a postponement of the scheduled rate reductions would also increase overall revenues, but in this case there might not be

more room for tax expenditures, since the revenue loss from tax expenditures as now measured would increase along with the increases in marginal tax rates.

APPROVAL BY OTHER COMMITTEES

In my view, limiting tax expenditure totals is less important than trying to devise ways to require the Congress to consider seriously the tradeoffs between tax expenditures and spending programs on a case-by-case basis. The requirement in S. 193 that new or modified tax expenditures be approved by the nontax committees with jurisdiction over analogous spending programs and by the Budget Committees would be an important step in that direction. It would enable the Congress to treat tax expenditures as more than just another kind of tax cut. They would be treated as what they are—an alternative to spending programs. By involving the committees that are responsible for allocating scarce resources to particular program areas, a better overall accounting of the resources going to these areas could be achieved, and end runs around the limitations of the budget process could be minimized.

The nontax committees are likely to have more expertise in the program areas involved than the tax committees, and thus may be better able to give tax expenditure proposals a critical evaluation. They could also determine more readily whether a tax expenditure would duplicate or overlap with similar spending programs, and might be able to suggest ways of coordinating the administration of the tax expenditure with that of similar spending programs. The Budget Committees, for their part, could determine whether the total of resources being devoted to a particular purpose through tax and spending programs was consistent with overall budgetary priorities.

One way of strengthening the incentive for the nontax committees to take the review responsibility provided in S. 193 more seriously would be to provide that their spending allocation be reduced commensurately every time they approved a tax expenditure that fell into their area of jurisdiction. This would give the nontax committees a real stake in whether or not tax expenditures in their area were increased, and would force them to make the difficult tradeoffs that are inherent in budgeting. It would also relieve some of the burden on the Budget Committees, which would no longer have to stand alone in seeking to impose the discipline of the budget process on tax expenditures.

This, of course, would represent a significant reallocation of authority and responsibility among committees in the Congress, just as the Budget Act itself did. If the Congress took this step for itself, it might also want to extend the same principle to the executive branch by providing that each department's spending allocation be reduced whenever tax expenditures in the same area were increased.

ANY CHANGE IN BUDGET PROCESS WILL ENCOUNTER RESISTANCE

In conclusion, as I always seem to say when I appear before the Budget Committees, none of the options you have are easy ones. Any attempt to impose more control over tax expenditures will be

resisted by those who benefit from them, just as control over spending programs is resisted by their beneficiaries. Any change in the budget process itself will encounter resistance within the Congress. But the gains in terms of greater control over the allocation of scarce resources, and a fuller awareness of all the ways in which the Federal Government influences private decisions, would also be substantial. Whether the gains would outweigh the costs is, as always, for you to decide.

Senator KASSEBAUM. Thank you very much, Dr. Rivlin.

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PREPARED STATEMENT OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

I appreciate this opportunity to testify on possible approaches to controlling tax expenditures. This is one of the important unresolved issues in the budget process, and I am pleased that Senator Kassebaum has taken the initiative to focus attention on it with her bill and with these hearings. In September of this year, the Congressional Budget Office (CBO) issued a report entitled "Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-1986," which contains extensive discussion of tax expenditures and the budget process. Copies of that report have been made available to this Committee. My testimony this afternoon is divided into three sections. The first discusses the importance of controlling tax expenditures, the second deals with possible alternative ways of controlling them, and the third focuses specifically on Senator Kassebaum's proposed "Tax Expenditure Limitation and Control Act" (S. 193).

THE IMPORTANCE OF CONTROLLING TAX EXPENDITURES

Tax expenditures have become one of the major ways in which the federal government allocates resources and affects private sector decisions. The most recent tax expenditure budget, compiled last March, included 104 items totaling $266.3 billion. The Economic Recovery Tax Act of 1981 added 8 new tax expenditures, expanded 22 others, and reduced 2.

In many areas, the federal government exerts more influence through tax expenditures than it does through direct spending. The tax expenditures for energy are greater than direct federal outlays, for example, and tax expenditures for housing exceed outlays by more than four to one.

In 1967, the first year for which an official tax expenditure budget was compiled, there were 50 items with a total revenue loss of $36.6 billion—20.5 percent of total federal direct outlays in that year and 4.4 percent of the gross national product (GNP). By fiscal year 1981, tax expenditures had grown to a total of $228.6 billion—34.6 percent of outlays and 8.0 percent of GNP (see Table 1).

Tax expenditures add to the federal deficit in the same way that direct spending programs do. They allocate resources and provide incentives and benefits in the same way that spending programs do. They are one of the ways the federal government plays a role in the economy and involves itself in the lives of its citizens.

But unlike direct spending programs, tax expenditures have low visibility in the budget process and are controlled in only a limited and indirect way. The Budget Act requires that a tax expenditure budget be compiled each year, but it is presented only for informational purposes. No direct budgetary decisions are based on it, and as a consequence it receives relatively little attention. One consequence of this low visibility is that activities that may not have sufficient support to obtain federal funding through direct outlays may be funded through the back door by tax expenditures.

Tax expenditures show up as revenue losses, and thus have an important effect on the revenue totals that are included in Congressional budget resolutions. But they are treated for this purpose as simply

TABLE 1. TAX EXPENDITURE GROWTH, CALENDAR YEARS 1967-1973 AND FISCAL YEARS 1975-1981[a]

	1967	1969	1971	1973	1975	1977	1979	1981
Tax Expenditure Totals (millions of dollars)	36,550	46,635	51,710	65,370	92,855	113,455	149,815	228,620
Percent of GNP	4.4	4.8	4.6	4.7	6.3	6.1	6.4	8.0
Percent of Federal Outlays	20.5	23.7	22.3	24.3	28.5	28.2	30.3	34.6
Percent of Federal Revenues	23.8	24.1	24.8	24.7	33.1	31.7	32.2	37.9
Federal Outlays as a Percent of GNP	21.4	20.3	20.6	19.5	22.0	21.6	20.9	23.1

a. Tax expenditure estimates were prepared only on a calendar year basis for the years 1967 to 1973. The estimates for calendar years 1967 to 1973 correspond roughly to fiscal years 1968 to 1974, and are thus compared to the GNP, outlay, and revenue figures for those fiscal years.

another form of tax cut; they are not treated as alternatives to spending programs. There is an important distinction between general tax cuts that reduce taxes broadly across the board, and tax expenditures that provide a tax cut only to those in certain specified circumstances, or who act in certain specified ways. General tax cuts return resources to people to use in whatever way they see fit; tax expenditures return resources to people only if they do what the government would like them to do, or if they are thought deserving of special help. The present treatment of tax expenditures in the budget process blurs this distinction.

ALTERNATIVE WAYS OF CONTROLLING TAX EXPENDITURES

Tax expenditures could be controlled in the same way direct outlays are. The Budget Committees and the Congress could vote on a tax expenditure budget, broken down into budget functions and subfunctions. Tax expenditures could be limited to specified amounts, and they could then be allocated to the committees with jurisdiction over them through a "crosswalk" procedure. If they were all allocated solely to the tax committees, however, they would end up being treated in essentially the same way as they are now—as just another form of tax cut. Allocating tax expenditures jointly to the tax committees and to the committees with jurisdiction over analogous spending programs would be one way of emphasizing their relationship to spending programs. This procedure would be similar in some respects to the way spending is now allocated jointly to

the appropriations committees and to the authorizing committees. Senator Kassebaum's bill contains a variant of this approach in its requirement that tax expenditures be approved by the Budget Committees and by the committees with authority over analogous spending programs.

Short of this, steps could be taken to increase the visibility of tax expenditures. The Budget Committees and the Congress could vote specifically on targets for tax expenditures, as they do now for loan programs in the credit budget. While nonbinding targets do not receive the same degree of visibility and attention as binding ceilings, this procedure would give tax expenditures more visibility than they now have. As more experience was gained with this approach, there could be gradual movement toward more binding limitations.

Alternatively, tax expenditures could be subjected to even stricter limits than are imposed on spending programs. Following the approach of the various spending limitation bills and constitutional amendments that have been introduced in recent years, total tax expenditures could be limited to some fixed percentage of GNP, federal outlays, total federal receipts, individual and corporate income tax receipts, or some other measure. Senator Kassebaum's bill, for example, would limit tax expenditures to 30 percent of total federal revenues. The growth in tax expenditures might also be limited to a fixed percentage amount, or tied to inflation, GNP growth, or some other measure. The problem with approaches that seek to use a fixed formula is that no formula can

automatically take into account all of the economic and political variables that are important in budget-making. That of course is one of the attractions of fixed-formula plans for those who do not believe that budgets should be affected by all of these variables, or who worry that the Congress will not reach the proper decisions if allowed to take these variables into account. The current budget process, by contrast, is designed to allow the Congress to take into account whatever factors it considers relevant in determining budget levels.

A further problem with imposing stricter budget controls on one type of federal activity than on others is that resources will tend to flow toward the less-controlled activity. The fact that both tax expenditures and loan programs have grown more rapidly in recent years than direct outlays is an illustration of this. Ideally, the budget process should treat all forms of resource allocation the same, so that decisions are based on the merits rather than on the type of budget control.

Limitations of the Arithmetic Total of Tax Expenditures

In discussing tax expenditures we frequently use their arithmetic total, as I have done this afternoon, but arithmetic totals have limitations for budget purposes. The problem with the arithmetic totals is both a conceptual and a practical one. Tax expenditures are revenue the government does not collect, so they can never be directly observed. Instead, they must be estimated, using a somewhat artificial set of assumptions and estimating conventions. The revenue loss from each individual tax expenditure is estimated by comparing the revenue raised

under current law with the revenue that would be raised if the provision had never existed. The major difficulties arise because of interactions with the standard deduction (zero bracket amount) and the income tax rate structure. If several tax expenditures that take the form of personal deductions did not exist, revenue would be higher by less than the sum of the tax expenditures, since more people would take the standard deduction. If several tax expenditures that take the form of exclusions from income did not exist, more income would be taxed at higher marginal tax rates, so revenue would be higher by more than the sum of the tax expenditures. This is spelled out in more detail in Chapter II of CBO's September 1981 report.

These interactions can be taken into account if a limited number of tax expenditures are being considered, but the calculation becomes increasingly more artificial as more items are included. Including all tax expenditures, and taking into account all of the interactions, would require constructing a wholly new tax system without tax expenditures. While this could be done, it would require making a large number of probably controversial assumptions. In the end, it would still be no more than an idealized abstraction. It would never have the reality that total budget outlays and revenues do.

Attempting to take into account all of the interactions needed to reach a theoretically correct total of tax expenditures could in fact impair the usefulness of the tax expenditure budget for one of its major purposes, that of comparing the resources being devoted to a particular

activity through direct outlays and through the tax code. The revenue loss attributable to each individual component of an integrated total would vary, depending on the assumptions used to calculate the total and the order in which each item was entered into the estimating model. There would no longer be a single number for each tax expenditure that was generally comparable to the estimates for individual spending programs.

TAX EXPENDITURE LIMITATION AND CONTROL ACT (S. 193)

S. 193 seeks to control tax expenditures by making two major changes in the Budget Act:

1) Budget resolutions would be out of order "if the level of revenue loss from tax expenditures contained in the resolution exceeds 30 percent of the recommended level for net revenue set forth in such resolution."

2) New tax expenditures, or modifications of existing tax expenditures, would have to be approved by the committees having jurisdiction over the activity that the tax expenditure affects, and by the Budget Committees, as well as by the tax committees. New or modified tax expenditures would also have to be reported by the May 15 deadline that applies to spending authorizations.

The second of these changes could lead to major improvements in the way tax expenditures are dealt with in the budget process. Before discussing this, however, I would like to talk briefly about the first part of the proposal.

Limiting Tax Expenditures to 30 Percent of Total Revenues

As my testimony so far has indicated, any limit on the total amount of tax expenditures must confront the fact that the total itself is a somewhat artifical number. In addition, as discussed earlier, limiting tax expenditures by the use of a fixed formula would impose on them a discipline that is more strict and rigid than that which now applies to spending programs. The better approach is probably to try, insofar as possible, to subject all forms of resource allocation to the same kind of budget control.

There are also some special problems in tying tax expenditures to total revenues rather than to some more general measure, such as the gross national product. Increases in excise taxes or a windfall profit tax on decontrolled natural gas would increase overall revenues, and thus permit an increase in tax expenditures--whether or not this was the desired result. An increase in income tax rates or a postponement of the scheduled rate reductions would also increase overall revenues, but in this case there might not be more room for tax expenditures, since the revenue loss from tax expenditures as now measured would increase along with the increases in marginal tax rates.

Approval by Other Committees

In my view, limiting tax expenditure totals is less important than trying to devise ways to require the Congress to consider seriously the trade-offs between tax expenditures and spending programs on a case-by-

case basis. The requirement in S. 193 that new or modified tax expenditures be approved by the non-tax committees with jurisdiction over analogous spending programs and by the Budget Committees would be an important step in that direction. It would enable the Congress to treat tax expenditures as more than just another kind of tax cut. They would be treated as what they are--an alternative to spending programs. By involving the committees that are responsible for allocating scarce resources to particular program areas, a better overall accounting of the resources going to these areas could be achieved, and end runs around the limitations of the budget process could be minimized.

The non-tax committees are likely to have more expertise in the program areas involved than the tax committees, and thus may be better able to give tax expenditure proposals a critical evaluation. They could also determine more readily whether a tax expenditure would duplicate or overlap with similar spending programs, and might be able to suggest ways of coordinating the administration of the tax expenditure with that of similar spending programs. The Budget Committees, for their part, could determine whether the total of resources being devoted to a particular purpose through tax and spending programs was consistent with overall budgetary priorities.

One way of strengthening the incentive for the non-tax committees to take the review responsibility provided in S. 193 more seriously would be to provide that their spending allocation be reduced commensurately

every time they approved a tax expenditure that fell into their area of jurisdiction. This would give the non-tax committees a real stake in whether or not tax expenditures in their area were increased, and would force them to make the difficult trade-offs that are inherent in budgeting. It would also relieve some of the burden on the Budget Committees, which would no longer have to stand alone in seeking to impose the discipline of the budget process on tax expenditures.

This of course would represent a significant reallocation of authority and responsibility among committees in the Congress, just as the Budget Act itself did. If the Congress took this step for itself, it might also want to extend the same principle to the executive branch by providing that each department's spending allocation be reduced whenever tax expenditures in the same area were increased.

CONCLUSION

As I always seem to say when I appear before the Budget Committees, none of the options you have are easy ones. Any attempt to impose more control over tax expenditures will be resisted by those who benefit from them, just as control over spending programs is resisted by their beneficiaries. Any change in the budget process itself will encounter resistance within the Congress. But the gains in terms of greater control over the allocation of scarce resources, and a fuller awareness of all the ways in which the federal government influences private decisions, would also be substantial. Whether the gains would outweigh the costs is, as always, for you to decide.

Senator KASSEBAUM. I would like to ask a question that I think is of some concern, although in your CBO report on tax expenditures you fairly clearly answer it.

Can you define tax expenditures?

Are we going to get in trouble in trying to determine what constitutes a tax expenditure?

Do you see any problem?

Dr. RIVLIN. I see some problems, but not really major ones. There are a lot of problems of definition in dealing with a budget even on the spending side.

I think agreement can be reached on what is a tax expenditure—it is basically a special provision giving some special tax advantage, as contrasted with the general tax rates and other general provisions that apply to everyone.

Senator KASSEBAUM. And you feel it would be better now to try and put—impose any limit on expenditures proportionate to revenue?

Would you try to put any limit in?

Dr. RIVLIN. No; I think it would make sense for the Congress to vote on a tax expenditure total, being conscious that there would be some uncertainties about that total. There are uncertainties about the spending number as well. What seems to me not a particularly good device is tying it to the revenue number itself.

My reason for saying that is simply that there is no obvious reason why you would want tax expenditures always to increase whenever there was a tax revenue increase for some reason.

Senator KASSEBAUM. I think that is a good point.

You want to put a ceiling on it.

Dr. RIVLIN. It seems to me that the most sensible thing is to treat tax expenditures symetrically with the spending side, and say that you will vote on them in the budget resolution, function by function.

Senator MOYNIHAN. Spending will be *x* and tax spending will be *y*, and you have a credit *z*.

Dr. RIVLIN. And credit, exactly.

MARGINAL TAX RATES HAVE RISEN DRAMATICALLY

Senator KASSEBAUM. On marginal rates, I would like to ask you this and I don't know whether there is any really good answer.

It is really a question of which comes first, the chicken or the egg. Effective marginal tax rates have risen dramatically and this increase is generally attributed to inflation-caused bracket creep. However, because of the additional loss of revenue from tax subsidies or expenditures haven't we had to have more dramatically increased marginal tax rates?

Dr. RIVLIN. Yes; both are true.

As you say, it is a question of which comes first. The increasing marginal tax rates increase the value of the tax expenditure and the incentive to those who benefit to keep it.

Senator KASSEBAUM. So as we could proportionately bring it down, of course, the goal would be to continue to bring the tax rate down, and this would effectively lower—continue to lower the marginal tax rate?

Dr. RIVLIN. Right.

Senator KASSEBAUM. Would that be a correct assumption to make?

Senator MOYNIHAN. Yes.

Senator KASSEBAUM. Senator Moynihan?

COMMODITY TAX STRADDLE LOOPHOLE CLOSED

Senator MOYNIHAN. Madam Chairman, I just want to offer a little encouragement on one point, by mentioning that in the last tax bill we closed one of the more gaping loopholes in a very long time, the commodity tax straddle which had the potential to zero-out the Federal revenue system.

It wasn't the most agreeable exercise; but in the end we picked up a minimum of $1.7 billion in revenues, over the next 5 years. And I might add, the commodity markets have not suffered.

To the contrary, in the long run, the markets will be much strengthened—by the knowledge that people pay their taxes once a year, as people are supposed to, and that the Finance Committee can generate needed reforms of tax expenditures. The committee reported and agreed to my proposal by a vote of 18 to 2, and the Ways and Means Committee accepted it as well.

And if I can just be a little bit academic, I wrote a little article about it for the New York Times last August, arguing that there can and will be more like it.

I wonder if I could ask that this be placed in the hearing record?

Senator KASSEBAUM. I would be happy to include it in the record.

[From the New York Times, Aug. 23, 1981]

A SENATOR'S RESPONSE: TAX REFORM LIVES!

(By Daniel P. Moynihan) [1]

In his assessment of the Economic Recovery Tax Act of 1981, "Reagan's dubious tax revolution" (Aug. 9), William Nordhaus wrote: "* * * the tax reform movement is utterly dead. Compared with earlier major bills—1964, 1969 or 1976—the current bill makes no pretense about closing the loopholes." Might a participant take another view?

Title V. of the new tax act, "Tax Straddles," ends a practice that arguably was the most threatening loophole in the history of the Internal Revenue Code. A tax specialist and member of the New York Bar Association put it last spring that unless stopped, commodity straddles would "zero out" the revenue system.

Straddles are simple enough in principle. A taxpayer enters one contract to buy and another to sell a given amount of a given commodity at some future dates, typically about two months apart in the coming tax year. Given normal price fluctuation, toward the end of the current year, one contract will have gained in value and the other will have lost. The taxpayer sells the contract that has lost value and is able to write off that loss on his income taxes. At the same time, the loss is only a paper loss, since it is balanced by the gain in the other contract. He then restraddles to offset his gain in the coming year, and continues to repeat this balancing process, effectively deferring taxes as long as desired.

The Joint Committee on Taxation has estimated that Title V. will save the Treasury $1.7 billion.

Donald C. Lubick, Assistant Treasury Secretary for tax policy under President Carter, grew concerned about this matter last December. We talked and agreed to send me a letter that was to be made public, in which he would describe a number of straddle cases taken from actual tax returns, without revealing names. The letter showed, among other things, partnerships that were clearly set up for the sole

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[1] Daniel Patrick Moynihan, a Democrat, is the senior Senator from New York and a member of the Senate Finance Committee.

purpose of incurring huge losses. There followed a flood of protests from those who felt their privacy had been invaded. The practice was already far more widespread than any one realized.

The occasion of Donald C. Regan's confirmation hearings as Treasury Secretary brought the matter more to the public's attention. It was reported in the press at that time that in its more arcane reaches his own firm, Merrill Lynch, was using a sophisticated variation of the straddle, called the butterfly straddle. Mr Regan has no involvement with that aspect of his firm's business, but quite agreed at the hearings that tax avoidance ought to be discouraged.

On March 5, I introduced a bill to prohibit straddles. It was a relatively crude device requiring that losses in commodities could be offset only against gains in commodities. But the object was sound enough. Our concern was that tax straddles were diverting "massive amounts of capital and entrepreneurial energy to the single purpose of avoiding taxes," as I told the Economic Club of New York that evening, all the result of a too complex tax code, with too high marginal rates of taxation. This was our argument. Nothing more. It was sufficient.

The tax section of the New York Bar came up with a better solution. Since gains and losses on commodities contracts are tallied at the end of each trading day with investors having to either make up for losses or take out profits, these are in every sense of the word *realized* gains and losses. Thus, have taxes levied on the net gain or loss at the end of the calendar year. Normal price hedging was exempted such that no one who, for example, produces wheat or consumes silver would be in the least affected. I revised our bill.

To keep the commodity markets attractive, and to make them even more *economic* institutions, as against machines for manipulating the tax code, we set a maximum tax rate of 32 percent on earnings, eliminating the six-month waiting period that entitles an investor to capital gains treatment.

On June 24, the Finance Committee adopted the revised bill by a vote of 17 to 2. And in the early hours of Aug. 1, the House, in conference, accepted the Senate provision, which is now law. Not only was a hemorrhage of revenues avoided, but the sharp loss of authority that would have come with the wider perception that there was a huge class of taxpayers paying little or no tax, or at any rate not paying tax once a year.

Not much fuss, and, accordingly from a certain point of view, not much fun. Certainly not as much fun as declaring the income tax system "a disgrace to the human race," as President Carter did in his 1976 acceptance speech. But for all the joys of villification, nothing came of the President's concern. Professor Nordhaus's chronicle of successful reforms ends in 1976.

It will disappoint many, but I dare to think the prospects for future reform are considerable. The new tax law forgoes huge amounts of revenue in the coming years. As deficits loom, the I.R.S. will be flogged into finding ways to increase revenues without seeming to increase taxes. In a word, to close loopholes.

Some businesses will become allies of closing loopholes. The Treasury will be bare. New privileges unthinkable. Logic, then, argues for trying to abolish the privileges of your market place competition. The first tentative soundings have in truth begun.

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Senator MOYNIHAN. I think you have done a wonderful thing here.

Senator KASSEBAUM. I would like to ask you as a member of the Finance Committee and of the Budget Committee, do you see this procedure working in relation to the obligations of the Finance Committee?

FIXED SUM CEILING WILL WORK BEST

Senator MOYNIHAN. I do. I think this procedure will work best with a fixed-sum ceiling rather than percentage arrangement. Say, for example, that tax expenditures this year total $212 billion. Is this much more or this much less than the previous fiscal year? And we could estimate out 3 or 4 years hence. That would be the considerations of most interest to the Finance Committee—what is

the amount of revenue involved in each particular tax expenditure, or each particular subsidy.

Senator KASSEBAUM. And then have the impact of it analyzed by the authorizing committees?

Senator MOYNIHAN. Senator Kennedy said there are situations, such as the earned income tax credit, where one portion comes through the appropriations process and another through the tax process. As usual it will get complicated, but the idea is not complicated. The idea is a clear and a good one.

Senator GORTON. I'd like to, for a moment, Dr. Rivlin, to relate these tax expenditures to general income tax rates.

Am I correct in my memory of the charts that have whistled past us today that tax expenditures now are of an amount that is approximately one-third or little more than one-third of all income tax collected?

Dr. RIVLIN. About one-third of total Federal revenues, which includes more than just income taxes.

WITHOUT TAX EXPENDITURES TAX RATE WOULD BE LOWER

Senator GORTON. That means that if we operated under a tax system in which none of these preferences existed, presuming we did not wish to increase revenues, could we lower every single tax rate from the bottom to the top by one-third?

Dr. RIVLIN. We could lower it by a lot. It probably would work out to less than a third. But it would be a very substantial cut.

Senator GORTON. Do you have any opinion as to the degree to which reductions in the maximum marginal rates reduce the pressures for any or all of these preferences?

Obviously if we have lowered corporate income tax rates to zero in many, many cases, some of the preferences which might otherwise be very valuable to corporations become irrelevant. I assume the same thing is true in connection with individuals, that is reducing the maximum rate from 70 to 50 percent reduces the pressure for many expenditures. At 40 percent, 35 percent, 30 percent, maximum rate, do many of these tax preferences lose their constituencies?

Dr. RIVLIN. I would think so. I don't know exactly at what point. You certainly got a good way in this direction by going from 70 percent to 50 percent. I think it probably depends on what you're talking about. An elaborate tax shelter, for instance, which will not cost less, is much less attractive at 50 percent than at 70 percent, and commensurately less at 40 percent. If it is just a question of exempting something like mortgage interest, for instance, which people are paying anyway, then getting 30 percent of that would not be trivial.

LOSS OF NORMAL TAX EXPENDITURES WOULD BRING CRIES

So one would expect that there would still be a great deal of hue and cry—and justly so—from those who would lose the benefit of a normal regular tax expenditure.

Senator GORTON. Unlike the 1978 Budget Committee report, this document which you have just committed to us does not go into these tax preferences item by item with any kind of description of

their original justification, their cost and degree which that justification is worth the cost, does it?

Dr. RIVLIN. We have done that in the past, and we have gone into particular ones in considerable detail.

I might ask Mr. Verdier to expand on this a little bit.

Mr. VERDIER. Yes; you're right, the last time we did do that compendium which gave a brief legislative history of the various tax expenditures was in 1978. We have an informal document that updates that, covering some of the more recent ones, mostly in the area of energy. We have also done a series of indepth papers on specific tax expenditure provisions such as industrial revenue bonds, the use of tax-exempt bonds to finance single family housing, real estate tax shelters, medical expense deductions, and employee exclusions for health insurance.

Senator GORTON. Have you attempted in each paper to reach a determination as to how much each one of these expenditures cost, with its actual impact to the extent that you can determine it? In other words, what we have got for what we pay?

Mr. VERDIER. That is what we try to do in each one of those studies, yes.

Sometimes there are limitations of data that don't allow us to do that completely.

Dr. RIVLIN. Always there are limitations.

Senator GORTON. Thank you.

Senator KASSEBAUM. Thank you very much, Dr. Rivlin.

We appreciate your testimony and we look forward to working with you as we consider changes we will be adopting.

Dr. RIVLIN. We stand ready to help and we can collect for you what we have already done and be responsive to other questions.

Senator KASSEBAUM. Thank you.

Professor McDaniel?

It is a pleasure to welcome Prof. Paul McDaniel, professor of law at Boston College Law School, and a Kansan by birth.

STATEMENT OF PAUL R. McDANIEL, PROFESSOR OF LAW, BOSTON COLLEGE LAW SCHOOL

Mr. MCDANIEL. That is right, a longer time than I might like to think.

I appreciate very much the opportunity, Madam Chairman, to appear and testify concerning the important matters which you have raised with the introduction of S. 193.

GROWTH OF TAX EXPENDITURES IN LAST DECADE

In my prepared statement,[1] which I will not read in its entirety, I do address some of the issues that prior witnesses have raised, namely, the question of the growth of tax expenditures in the past decade.

One measure of that growth that has not been mentioned which is relevant is the relationship of tax expenditures to GNP. In fiscal 1982, I estimate that tax expenditures will equal 8 percent of GNP. By contrast, the figure was 5.7 percent in 1976. That growth can be

[1] See p. 51.

compared to the slight increase during the same period by direct expenditures as a percentage of GNP represented. Thus, while the intervention in the economy by means of direct spending measured as a percent of GNP actually seems to be on the decline, we have had about a 40-percent increase in tax expenditures as a percent of GNP during the past 6 years.

This process is going to continue as the result of the 1981 act. According to the figures released by the staff of the Joint Committee on Taxation in connection with the 1981 act, it appears that tax expenditures will increase by some $280 billion over the next 5 years by virtue of the increases and new tax expenditures included in that measure.

This problem of aggregate levels of Federal spending through the tax system is an important matter, and one to which your limitation system directs itself.

PAY MORE ATTENTION TO TAX EXPENDITURES BEFORE ENACTING THEM

There is another aspect of the tax expenditure problem, to which I think Senator Gorton alluded, which is that a lot more attention needs to be given by Congress to particular tax expenditures before they are enacted and to evaluating the effects of those particular provisions which are enacted.

I think that aspect has important implications for the operation and carrying out its responsibilities by the Budget Committee.

I would like to illustrate this point by one provision in the 1981 act, the so-called safe harbor leasing rule, that was included in that act. This provision, as you know, was included because it was feared that a great many companies would be thrown into a tax loss position by virtue of the new depreciation rules, and thus would be unable to utilize both the benefits of those rules and the investment credit.

I am not at all sure that Congress understood that, in enacting the safe harbor leasing rule, it was introducing a new kind of Federal transfer payment system which is quite different from other direct transfer payment programs which are in effect. The new system operates by businesses with tax benefits that they cannot use offering those benefits to businesses that can use the tax benefits. In effect, thus, there is a Federal transfer program in which funds that otherwise would wind up in the Treasury are transferred to loss corporations. That transfer could have been effected directly, either by direct payments or by refundable tax benefits.

What difference does it make whether we run this new transfer program through the tax system, through this new transfer mechanism, directly, or by a refundability mechanism? First, if we had implemented the program through the refundability mechanism, the budget result would have been that the refundable portion would have been treated as an actual outlay under the Budget Act. And, then those outlays would have been subject to the limitations of the budget resolutions with respect to direct outlays. As it is presently run, this transfer program is not subject to the outlay limits.

Second, the refundable portion of the transfer payments would have been funded through taxes actually paid by other corporate taxpayers under the safe harbor leasing system. Other corporations may pay no taxes at all and, indeed, there is the potential that the Treasury will collect no Federal corporate income tax at all if this system is used to the maximum.

The third thing, of course, is that running the business transfer program through the safe harbor leasing mechanism means that, when outlays must be reduced, this transfer payment system is totally exempt from congressional review of the extent to which we ought to continue the Federal transfer program. Instead the entire burden of reducing Federal transfer programs falls on direct expenditures.

I think you can understand what this new transfer system is like if you think about one of the direct transfer programs we have in effect. That is the food stamp program. We could use this same mechanism in the food stamp program by first converting the food stamp program into a tax credit. Then, any taxpayer with a tax credit in excess of tax liability would be entitled to sell the excess tax credits to any other individual, and the purchaser could take those tax credits in his own individual tax return. By this technique, the entire Federal food stamp program would no longer constitute a budget outlay, and it would be removed entirely from the scrutiny that direct outlay programs incur. And that is exactly what has happened in the transfer program for loss corporations through the safe harbor leasing system.

EFFICIENT RUNNING OF TAX EXPENDITURE PROGRAMS SHOULD BE OF CONCERN

Another problem with which the committee, of course, must be concerned, in its role as a Budget Committee is whether these tax expenditure programs are being run efficiently.

The business transfer payment program might not arouse particular problems if there is a dollar benefit to the corporations Congress desires to help for each dollar of Federal funds expended through the system. Unfortunately, that does not seem to be the case. In the safe harbor leasing transactions I have seen, and have seen described, it appears that in most instances the present value of the tax benefits is in the neighborhood of 30 to 37 percent of the purchase price of the equipment. According to reports in the Wall Street Journal, it appears that around 16 to 27 percent of the actual benefits is being offered for these tax benefits.

You can think about this result in terms of a commission system. In other words, profit corporations are being given a commission to deliver the Federal transfer checks to the loss corporation. Based on examples to date, it appears that about a third of the cost of the transfer program is going to be siphoned off by profit corporations as a kind of commission for delivering the Treasury check to the loss corporations.

TAX BENEFITS COST TREASURY MORE THAN APPEARS

I included in my statement a series of transactions, actually entered into which were reported by the Wall Street Journal.

These reports, typically, give the total cost of machinery and equipment involved in the deal, and how much was paid for the tax benefits. What is not given is the total top revenues involved in the transactions. This committee should request the Congressional Budget Office to take those examples and tell you, not what was paid for the tax benefits, but what were the total amounts of Federal revenues involved in those transactions. I calculate that roughly $1.6 billion was paid for the tax benefits in the Wall Street Journal examples. I would guess on the basis of what I have seen you will find the actual Treasury cost is about $2.6 billion.

This result should be a matter of real concern in a situation in which the budget is so tight.

Senator GORTON. And that $1 billion difference is divided between the company which purchases the credit and the broker?

Mr. MCDANIEL. And the broker.

Actually, that is not so. It appears that in some deals, at least some I have seen reported, the buying company keeps that $1 billion, the broker's share comes out of the $1.6 billion which goes to the loss company.

Senator GORTON. So it is even greater.

Mr. MCDANIEL. It may vary from deal to deal. At least, in some I have seen reported, the seller bears the burden of transportation fees. As I say, this kind of wastage really can't be accepted when Congress has limited funds available for various programs, especially when there are mechanisms even within the tax system itself to use to eliminate the waste.

OBJECTIVES NOT BEING ACHIEVED IN SAFE HARBOR LEASING

If the objective is to get $1.6 billion to these loss corporations, we don't have to give a billion dollars to other profit corporations to do it. Conversely, it may be we really would like to have $2.6 go to the loss corporations to assist them getting back on their feet. Neither objective is being achieved in the safe harbor leasing arrangement as it is now set up.

I have reviewed in my prepared testimony past efforts to achieve both of these equally important budget objectives: One, control over aggregate levels of tax expenditures; two, insuring that the individual tax expenditures we do use are efficient and are rationally coordinated with the direct spending programs.

The lack of success in achieving these objectives through various techniques that have been tried in Congress under the Budget Act lead me to two or three conclusions: One, the Budget Act procedures simply are not adequate to bring tax expenditures under control in terms of the aggregates; two congressional procedures are not adequate either to provide the requisite coordination between tax and direct spending or to insure the requisite evaluation of tax spending be undertaken in a systematic and effective manner.

This, then, brings me to S. 193 and its provisions. Here I second the comments of Dr. Rivlin; it seems to me that the second part of the approach in S. 193 moves us along toward the achieving of the second objective I mentioned above.

For example, in terms of the safe harbor leasing provision itself, if the joint referral procedure had been required, and the safe harbor rule had been referred to another committee prior to its coming to the Senate floor, it is just possible the necessary cost benefit analysis and understanding the rule's function as a transfer payment program would have been undertaken and recognized. Then corrective steps might have been taken in order to eliminate some of the waste, even if the Senate decided to go ahead with the program.

Therefore, it seems to me the proposal for joint referral of tax expenditures provides an opportunity for the authorizing committees and this committee to ask two questions: One, is this program needed, and is it structured in an efficient way, taking into account the way we would structure direct programs?

Two, the procedure would give the Senate an opportunity to ask the question, are we already spending money in this area, and thus is this program needed or is it consistent with the way we are spending money in a given area?

On that latter question, I once took a look at tax expenditures for farm operations and compared them with direct expenditure farm programs. It was somewhat surprising to find that, whereas direct spending programs primarily are directed trying to assist small family farms, the tax expenditure programs had, in effect, the result of freezing out new small farmers trying to get in business. The result occurs because the tax expenditures operate primarily for the benefit of those higher income farmers who already have established their successful farms.

PLACE CEILING ON TOTAL SPENDING FOR GIVEN BUDGET FUNCTION

In the long run, I agree with the suggestion made by Senator Kennedy that ultimately the executive branch of the Government and Congress are going to have to place overall ceiling on total spending, in a given budget function, and both the executive branch departments, and congressional committees, are going to have to meet those ceilings, taking into acount both direct and tax spending.

The initial reports that have come from Canada, where a somewhat similar system is in effect, indicates, that this approach has put a great deal more discipline into the tax expenditure and direct expenditure process. It has alleviated the problem encountered in the Unites States where executive branch departments rather indiscriminately endorse any and every type of tax expenditure when they, themselves, are up against their direct outlay limits.

I think that S. 193 does move very usefully in the correct direction.

I do have some reservations with the spending limitations approach in S. 193. I would approach the matter by asking the question this way: Since every tax expenditure program as far as I know is really the functional equivalent of an entitlement program, would the committee's budget reports conclude that it make sense to control direct entitlement programs by limiting them to a percentage of direct revenues? If such a limitation would make sense for direct entitlement programs, then it would make sense

for tax expenditures. If it doesn't make sense for direct entitlement programs, then one ought to have similar reservations for tax expenditures.

But other than that, I will leave the matter to your budget experts and not opine as to the appropriateness of the limitation approach in S. 193, other than to observe that the two forms of spending ought to be treated alike.

I will pause with those comments.

Senator KASSEBAUM. Thank you very much.

PREPARED STATEMENT OF PAUL R. McDANIEL, PROFESSOR OF LAW, BOSTON COLLEGE LAW SCHOOL

INTRODUCTION

I appreciate the invitation of the Committee to appear and discuss questions of critical importance to continuing governmental efforts to obtain more effective control over the Federal Budget. These questions involve:

-- In an era of limited Federal resources, how can Congress insure that Federal spending programs run through the tax system represent an efficient use of Federal revenues?

-- In a time when Congress is striving for a balanced budget, how can the largely unchecked spending through the tax system be curtailed?

-- In a decade when the competition for Federal funds can be expected to result in close scrutiny of the need and effectiveness of direct spending programs, how can Congress insure that tax expenditures are subjected to that same evaluation discipline?

The efforts of this Committee to address these questions are both timely and necessary if Congress is to realize its goals of a balanced and efficient Federal Budget.

I. The Growth of Tax Expenditures

The growth of tax expenditures in recent years leaves little doubt that renewed Congressional attention to this burgeoning area of the Federal Budget is urgent. The initial tax expenditure budget submitted by the Treasury in 1968 revealed some 40 separate programs. By 1976 the number of programs had doubled to 80 and for fiscal 1982, the total is

expected to rise to 104. The revenue cost of tax expenditure programs has risen even more dramatically: From a $44 billion level in 1968, to over $97 billion in 1976, to an estimated $266 billion in 1982. Thus, tax expenditures have contributed dramatically to the growth of government since 1968. There has been a 150% increase in the number of programs and more than a 600% increase in revenue costs for tax spending programs. Tax expenditures for fiscal 1982 will equal about 8% of GNP; but in 1976, tax expenditures were only 5.7% of GNP. There has thus been a 40% increase in the percentage of GNP represented by tax spending programs in only six years.[1]

The rate of growth in tax expenditures has substantially exceeded that of direct expenditure programs. For example, in 1976 direct outlays were 22.7% of GNP and that number under President Carter's fiscal 1982 Budget was expected to increase only slightly -- to 23% -- in 1982. Moreover, the trend in direct outlays is actually down, since direct outlays equaled 23.3% of GNP in 1981.[2] Thus, as a percent of GNP, direct expenditures increased only slightly between 1976 and 1982 and, in light of recent Congressional actions, may be on the decline. This record on control of direct expenditures stands in sharp contrast to the unchecked and dramatic increases in tax expenditures as a percent of GNP.

Moreover, the rate of increase in total direct outlays has been substantially less than that of tax expenditures. In 1968, direct outlays totalled $178.8 billion. In 1976 that figure rose to $366.4 billion, and in 1982 outlays are expected to total over $700 billion.[3] Thus, whereas the total of tax expenditures in 1982 is over six times greater than the total in 1968, the total of direct expenditures is only about four times the 1968 total.

By whatever measure, the record clearly establishes that the one element of the total Federal Budget that has been and is out of control is the tax expenditure component.[4]

II. The Impact of the Economic Recovery Tax Act of 1981

A. Overall Effects on Tax Expenditures

The recently passed Economic Recovery Tax Act of 1981 offers some instructive illustrations of the impact of tax expenditures in terms of total Federal spending and in terms of the ability of Congress effectively to control particular spending programs.

-- For individuals, new and expanded tax expenditures of a general nature will total an estimated $94.7 billion for the five-year period 1982-1986.

-- For business, new and expanded tax expenditures will total an estimated $149 billion for the five-year period.

-- For savings, new and expanded tax expenditures will total an estimated $17.9 billion over the five-year period (reductions in tax expenditures in this area will total $2.5 billion).

Thus, the 1981 Act will add $261.6 billion to tax expenditure budgets over the next five years from the changes and additions it made to the existing tax expenditures list. (Against this figure may be netted the $2.5 billion in reduced tax expenditures for savings and, perhaps, the $1.7 billion revenue gain from changes in the provisions applicable to "tax straddle" transactions).[5]

On the other hand, the total of tax expenditures for individuals will be reduced as the rate reductions for 1982 and 1983 take effect. This phenomenon occurs by virtue of the fact that revenues expended for tax expenditures effected by means of special exclusions from income, special deductions, and special exemptions rise when tax rates are increased and fall when tax rates are reduced. That is, when Congress increases tax rates it automatically increases federal spending through the tax expenditures whose cost is a function of tax rates; correspondingly, when tax rates are cut, Congress simultaneously reduces federal spending programs effected by means of special exclusions, deductions and exemptions.

B. The "Safe Harbor Leasing" Rules

The particular problems that this Committee faces when dealing with tax expenditures may be highlighted by focusing in more detail on one of the new tax expenditures created by the 1981 Act -- the "safe harbor leasing" provision included in the new Accelerated Cost Recovery System.[6] The safe harbor leasing rule (SHL) was enacted because the depreciation deductions awarded under ACRS were so excessive that many companies could find themselves in a tax loss position, unable to use currently their investment credits and perhaps even part of the ACRS deduction itself. That result was deemed undesirable by the Administration and Congress, presumably because the permissible carryback and carryover of the excess tax benefits diluted the desired incentive effect of ACRS and the investment credit.[7]

One solution to this issue would have been to have made the excess tax benefits refundable. As to ACRS, the Treasury could have been authorized to deliver a check to a business whose ACRS deductions exceeded income. The check would have represented an interest free loan repayable to the Treasury over a specified time period. Likewise, unused investment credits could have been refunded to a "tax loss" business. Since the investment credit is the functional equivalent of a direct Government grant, the business would simply have retained these Treasury funds. Refundable tax benefits are themselves, therefore, the functional equivalents of direct Federal transfer payment programs, such as food stamps, etc.

The SHL rules were viewed as an alternative to the refundability approach. Under SHL, the business receives its Federal transfer or welfare payment by selling its excess tax benefits to a profitable corporation. The program beneficiaries thus receive immediate cash and the profitable corporation reduces or eliminates its Federal corporate income tax by using its acquired tax deductions and credits.

But the SHL approach produces dramatically different results from refundability -- differences which should be of critical concern to the Congressional Budget Committees.

First, the comparability of SHL to refundable tax benefits makes clear that SHL is simply a method of effecting Federal transfer payments to qualifying businesses. Instead of having the Treasury issue the business welfare checks directly to a tax loss company, profitable corporations were selected as the agents to deliver the Federal transfer payments. From a budgetary standpoint, the SHL approach thus introduced an alternative method for implementing Federal transfer payment programs. The important question is whether this alternative method is subject to the same budgetary scrutiny as are the direct transfer payment programs for individuals such as food stamps, Social Security, AFDC payments and the like.

It appears that the SHL method of effecting Federal transfer payments opens a singificant loophole in the Budget process. Had the excess

ACRS and investment credit benefits been made available to loss businesses through the refundability mechanism, the following Budget results would have occurred:

-- The refundable portion of the business benefits would have been funded out of actual taxes paid by profitable corporate taxpayers.

-- The refundable portion of the business benefits would have constituted "outlays" for Budget Act purposes and hence would have been subject to the limitations of the Budget Resolutions applicable to all direct outlay programs.[8]

-- When reductions in direct outlays were thought necessary, the business welfare outlay programs would have been required to compete with individual welfare programs in the process to establish Congressional spending priorities under a reduced budget.

Under the SHL system of delivering the Federal transfer payments to tax loss companies, the following Budget results are produced:

-- Profitable corporate taxpayers are not required to pay any corporate taxes to help fund the business welfare programs.

-- The transfer payments do not constitute "outlays" under the Budget Act,[9] and hence are not subject to any limits on Federal "outlays" in the Budget Resolutions; moreover, since profitable corporations are not required to pay any tax under the SHL approach, they are exempted from contributing to revenues goals established by the Budget resolution and thus all revenues must come from taxes imposed on bases other than corporate profits.

-- When reduction in Government outlays are thought desirable, the SHL approach completely exempts the transfer payments to business from the discipline of establishing priorities among existing Federal

transfer programs; as a result the only transfer programs subject to reduction are those for individuals which are paid by actually issuing Government checks.

The potential Budgetary danger of the SHL approach for delivering Federal transfer payments can be illustrated by the following example. Assume that the food stamps program was converted to a "food stamps tax credit." Those eligible for the tax credit would then be permitted to sell their credits to higher income individuals to the extent the allowable credits exceeded tax liability. The purchasers could then reduce their individual income tax liability by using the acquired tax credits. By this simple technique the food stamps program could be removed almost entirely from the controls of the Congressional Budget process.

The Congressional Budget Committees thus urgently need to scrutinize the SHL provisions with particular attention to questions such as the following:

-- In times when Federal transfer payment programs must be reduced because of limited budget resources, why is the business transfer payment program exempted from any reductions so that the entire burden of program cuts must be borne by transfer programs that benefit low-income and elderly individuals?

-- In general, is it desirable virtually to exempt a Federal transfer program from the Budget process simply because a different method for delivering the program payments is adopted?

-- More broadly, why is the Federal government now employing a "two-track" transfer payment system, one for individuals and one for business?

The SHL system also raises another question with which Congress generally and the Budget Committees in particular must be concerned. In an era of limited Federal resources, it is vital that Federal transfer payment programs operate as efficiently as possible. Thus, the SHL

technique must be examined closely to see if it is cost-benefit effective. That is if the objective is to provide Federal payments to ailing businesses, is $1 of Federal revenue cost translated into $1 of benefit to the program beneficiary? In recent public discussions of SHL, attention appears to have focused exclusively on the question whether the estimated revenue losses from SHL will exceed those anticipated at the time of enactment.[10] This is a valid and important question for the Budget Committees to consider, but it is not the only question.

Under the SHL system, profitable corporations are in effect designated as the agents to deliver the Federal transfer payments to loss corporations. The preliminary indications are that the these delivery agents are siphoning off a substantial "commission" to compensate themselves for acting as delivery agents. This fact is readily apparent from an example that appeared in the recent explanation of the SHL provisions issued to the Staff of the Joint Committee on Taxation.[11] (See Appendix A.)

The JCT example assumed that X Corporation purchased equipment for $1 million. X Corporation sold those tax benefits to Y Corporation for $200,000 in a "sale-leaseback" transaction. The net present value to Y Corporation of the investment credit, ACRS depreciation deductions, interest expense deduction and rental income equalled $321,000. Thus, Y Corporation in effect received a $121,000 "commission" from the Treasury for delivering a $200,000 Treasury check to X Corporation. Or to put the matter another way, it cost the Treasury $1.60 to deliver each $1 dollar of transfer payment to X Corporation. Put still differently, if the objective is to deliver $200,000 to X Corporation, the Treasury could have saved $121,000 by just issuing the check itself (e.g., through a refundability mechanism). Or still differently, if the objective is to get $321,000 of tax benefits to X Corporation, almost 40% of that amount was wasted because of the delivery mechanism selected.

The JCT example appears closely to reflect the realities of what is ocurring in the SHL market. In general, the net present values of tax benefits for equipment appear to range from 30 to 37% of the cost of the equipment. But the prices being paid for those benefits appear to range from 16-27% of the benefits.[12]

The Budget Committee urgently needs to examine the efficiency of the SHL system in carrying out its obligation to insure that limited Federal funds are being expended in the most efficient manner. Attached as Appendix B to this statement are reports of SHL transactions that have appeared in the Wall Street Journal. In most instances, the reports provide the total cost of the equipment and the amount paid by the purchaser of the tax benefits. The amounts paid for the tax benefits in these examples appear to total over $1.6 billion. The Committee should instruct the Congressional Budget Office to estimate in present value terms the actual total revenue cost to the Treasury of these transactions. It can be anticipated, based on the foregoing, that the cost to the Treasury substantially exceeds the $1.6 billion in transfer payments received by the selling corporations. The Committee and Congress then need to consider whether the "commission" or "waste" element inherent in SHL can be tolerated under present Budgetary conditions, especially given the fact that mechanisms exist even within the tax system to deliver the transfer payments without the waste or commission element that is present in the SHL mechanism.

The experience with tax expenditures under the 1981 Act is thus illustrative of the fact that this form of Federal spending is still largely outside effective control under the existing Congressional Budget process. Aggregate spending through the tax expenditure mechanism will continue to escalate even as Congress painfully seeks to bring direct spending under control. And the requisite Congressional scrutiny to test individual tax expenditure programs for need, efficiency and cost effectiveness is simply not being undertaken before tax programs are enacted.

III. Efforts Under Existing and Proposed Procedures to Control Tax Expenditures

S.193, introduced by Senator Kassebaum, proposes a new and imaginative approach to try to bring the tax expenditure component of the Budget under more effective control. Before evaluating the proposal it is instructive to place that proposal in the context of previous efforts and proposals in Congress to exert greater control over tax expenditures.

A. The Experience Under Existing Procedures

Since the 1974 Budget Act formally subjected tax expenditures to the Budget process, a number of efforts have been made under existing Act procedures to control aggregate and individual tax expenditures. The following discussion briefly summarizes those efforts and evaluates the results of the experience to date.[13]

In the fiscal 1976 and 1977 Budget Resolutions, the Senate Budget Committee Reports contained language which required that the applicable revenue figure in the Budget Resolutions be reached in part by specified dollar reductions in existing tax expenditures. The Revenue Act of 1976 provided a test for the effectiveness of this procedure. An initial problem with the Budget Committee approach was that the required reduction in tax expenditures was not specified in the Budget Resolution itself. Moreover, the Budget Act process itself proved unable to prevent passage of an avalanche of tax expenditures on the Senate floor which were completely at variance from the assumptions underlying the Budget Resolution. Nonetheless, in the Conference Committee deliberations on the 1976 Revenue Act, the Budget process discipline appeared to reassert itself and the resulting reductions in tax expenditures were not far short of the reductions sought by the Senate Budget Committee. The 1976 experience

revealed two major lessons with respect to the use of Budget Act processes to control tax expenditures: (1) The required action with respect to tax expenditures would have to be spelled out in the Budget Resolution itself; and (2) Budget Act procedures standing alone could not prevent Senate floor adoption of tax expenditures which were inconsistent with the Budget Committee. assumptions concerning the treatment of tax expenditures.

In 1975, repeal of part of the tax expenditures for the oil industry -- the percentage depletion deduction -- was achieved by a Senate floor amendment to the Budget Resolution to require increased revenues. However, in 1977, Senate proponents of tax expenditures for education costs used the same procedure to amend the Budget Resolution to provide revenues adequate to fund a tuition tax credit program. Thus, attempting to control tax expenditures by individual floor amendments to the Budge Resolution does not seem likely to represent a real solution to the problem. Applied neutrally, the procedure is at least as likely -- perhaps more likely -- to result in increased rather than decreased tax expenditures. In either event, the procedure is really antithetical to the Budget Act process since the Budget Resolution is not intended to require specified action with respect to particular spending programs, whether those programs are in the form of direct outlays or tax expenditures.

The Budget Resolution for Fiscal 1979 again dealt with the tuition tax credits. During 1978, Congress adopted the Tuition Tax Credit Act of 1978, but at the same time also approved a competing program of direct eduction benefits proposed by President Carter. The Budget Committees attempted, through the Budget Act process, to force Congress to choose between one of the two approaches. While only the direct spending approach was adopted, that result occurred only because of the failure of the House

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and Senate to agree on the scope of a tuition tax credit, not because the Budget Act process had succeeded in forcing Congress to make a choice between two alternative approaches to education subsidies. The Budget process as then and presently constructed simply does not contain the sanctions necessary to enable the Budget Committees to require that choice.

The Budget Act process somewhat accidentally aided in controlling the expansion of tax expenditures during the Senate consideration of the Revenue Act of 1978. Initial floor amendments considered by the Senate used up the revenue "room" available under the 1979 Budget Resolution; cloture was then invoked and most other tax expenditure amendments became subject to a point of order. The 1978 combination of Budget Act rules and cloture is not likley to represent a long-term solution to control of tax expenditures. In this first place, the Senate is not likely to vote cloture with respect to most tax bills. But even if it were to do so, the resulting process is inherently disorderly and irrational. Since Senate floor amendments are generally taken up in no predetermined order only those tax expenditure amendments -- whether constituting increases or reductions -- that are brought up for consideration prior to reaching a combination of Budget Resolution limits plus cloture can be considered. The resulting race for Senate floor consideration by Senators with amendments affecting tax expenditures does not appear likely to produce systematic and effective control over Federal spending through the tax system.

From time to time, those favoring reductions in particular tax expenditures have offered amendments coupling reductions in tax expenditures with a provision to use the resulting increased revenues to provide a general corporate or individual rate reduction or to provide funds for direct spending programs. Congressional procedures make it difficult to

a vote on the combined package and the result has usually been adoption of the tax cut, but rejection of the proposed reduction in tax expenditures.

Finally, the "reconciliation" procedure adopted in 1980 did effectively produce a reduction in certain tax expenditures.[14] It is not clear, however, whether the reconciliation procedure is one that can be adopted every year. Moreover, the reconciliation procedure itself only required the tax-writing committees to increase revenues by a specified amount. That result can be achieved by the tax writing committees by tax increases, by reduction in tax expenditures, or a combination of the two. There is thus little guarantee that the reconciliation process, even if regularly used, will be able to effect systematic control over tax expenditures.

B. Proposals to Subject Tax Expenditures to More Effective Controls

As the above discussion indicates, the existing Budget process cannot adequately control spending through the tax system. The Budget Act itself only requires: (1) A tax expenditure budget to be submitted by the President: (2) Inclusion in the Budget Committee reports of five-year projections of tax expenditures by budget function; and (3) Inclusion in all committee reports of five-year projections for new or increased tax expenditures provided by the bills which the reports accompany. The use of extra-Budget Act procedures to control tax expenditures has been only sporadically and partially successful. This unsatisfactory situation has led to proposals which would subject tax expenditures to more careful scrutiny and which would provide for a greater coordination of tax and direct spending programs in the same budget function category. The principal proposals of this type are briefly outlined in the following discussion.

It should be noted at this point that the Budget Resolutions may provide one indirect control on tax expenditures. The Second Budget Resolution does establish a revenue floor which must be met. The revenue floor, once established, cannot be breached by revenue reduction measures, whether in the form of a general tax cut or by adding new or increased tax expenditures. The problem has been that generally the revenue floor is established after it is apparent what direction Congress has taken or will take with respect to new or expanded tax expenditures. Thus, the floor too often has been a reflection of tax expenditure actions already taken, or contemplated, rather than serving as a barrier to new or expanded tax expenditures. Up to the point of the adoption of the Second Budget Resolution, the revenue figure in the First Budget Resolution is simply a target, and it can be met by general tax increases or reductions as well as by increases or decreases in tax spending.

One approach to exerting greater Congressional control over tax and direct spending has been embodied in the "sunset" legislation which has been considered by Congress over the past five years. This legislation would subject Federal spending programs to periodic review and evaluation, with termination of a program to occur in the absence of an affirmative Congressional vote to extend it. It is readily apparent that if the sunset approach is to be effective, it must be equally applicable to tax and direct spending programs.[15] Congress is not yet satisfied that the sunset approach is feasible and it thus appears doubtful at this time whether that approach offers a likely avenue to achieve greater control over tax expenditures.

On occasion, Congress has written a sunset requirement into individual tax expenditure provisions by placing a time limit -- usually five years -- on the availability of the provision.[16] Experience to date has not provided

much assurance that the contemplated review and evaluation of the tax expenditure in fact results from the sunset provision. Too often, Congress has merely extended the provision -- sometimes even retroactively -- without requiring the studies and data necessary to evaluate carefully the tax expenditure program.

In recent years, others have proposed to control government spending by limiting expenditures to a specified percentage of GNP. Again, analysis has shown that such a limitation is meaningless unless it applies both to tax and direct expenditure programs.[17] However, Congress has not seen fit to adopt this relatively crude approach to spending control generally and it thus seems doubtful that tax expenditures will be controlled by such a mechanism.

Congressman Daschle recently introduced a resolution to require reductions in tax expenditures proportionate to the reductions being made in direct spending programs.[18] Still other suggestions have been made that the Budget Resolution itself address directly the level of spending to be carried out through the tax system. For example, the Budget Resolution might place a ceiling on the aggregate revenue loss that would be permitted for a fiscal year via the tax expenditure route.[19] Alternatively, the Budget Resolution might require a specific dollar reduction in tax expenditures from the existing level. The problem with all these approaches, however, is that the Budget Resolution figure (or tax expenditure reduction figure) may be met without any changes in tax expenditure programs at all. Thus, for example, under certain circumstances it is possible that a required dollar reduction in tax expenditures might be met by a general or selective rate cut since, as discussed above, all tax expenditures in the form of special exclusions, deductions and exemptions are automatically reduced when rates are reduced.

One issue presented by tax expenditures which none of the above proposals have addressed is the necessity to coordinate tax and direct spending programs in the same budget function. This problem led Senator Kennedy in 1978 to propose that any bill reported by the Senate Finance Committee which contains or extends a tax expenditure, or any such floor amendment offered by, on behalf of, or with the approval of the Finance Committee, would have to be referred to the Appropriations Committee before it could be considered on the Senate floor.[20] Senator Biden, moving along similar lines, has introduced S.582 to require authorizing legislation for any new tax expenditure such as that required for direct spending programs.[21] These approaches to control of tax expenditures will be considered below in connection with the discussion of a comparable proposal in S.193.

C. Lessons from the Experience to Date

The above sketch of efforts since the enactment of the 1974 Budget Act to bring tax expenditures under more effective control lead to the following conclusions:

1. The present procedures under the Budget Act are inadequate to insure that tax expenditures will be subject to the same budgetary discipline as exists with respect to direct spending programs.

2. Ad hoc procedures available outside the Budget process offer little prospect for rational and effective Congressional control of tax expenditures.

3. There is no existing procedure which provides the coordination between tax and direct spending programs which is necessary to avoid wasteful program duplication and inefficient, even counter-productive, expenditures of federal funds through the two forms of spending.

It is against this backdrop of experience and analysis to date that the suggested changes in S.193 may be considered.

IV. The Approach of S.193

S.193 proposes a two-part approach to enable Congress more efficiently to control tax expenditures.

First, the bill would amend the Budget Act to provide that the revenue loss from tax expenditures cannot exceed 30 percent of the recommended level for net revenues set forth in the applicable Budget resolution.[22]

Second, the bill requires (1) that all legislation enacting new tax expenditures, or modifying existing tax expenditures, be authorized by the committee with legislative jurisdiction over the activity affected by the proposed tax expenditure legislation; (2) such tax expenditure legislation must also be referred to the Budget Committee and be reported favorably by that Committee; and (3) any such tax expenditure legislation must be reported to the House or Senate by May 15. (The foregoing requirements would be subject to waiver under section 402(c) of the Budget Act.)[23]

In evaluating the first part of S.193, it is necessary to answer the following question: Would a similar limitation imposed on direct entitlement programs represent sound budget policy? It is essential for the Committee to get an answer to this question from its budget experts because if a proposal to limit direct entitlement programs to a percentage of revenues is unsound as a budgetary matter, than it is likely to be equally unsound as a method of limiting tax expenditures. Conversely, if such a limitation would constitute a sound measure, from a budget policy perspective, of limiting direct entitlement programs, then a limitation

on tax expenditures such as that proposed in S.193 would appear appropriate also. Of course, if the approach suggested by S.193 is sound budget policy, it could be adopted for tax expenditures without applying it to direct entitlement progams.

The reason why the limitation approach of S.193 must be tested in terms of its applicability to direct entitlement programs is that virtually all -- indeed, perhaps all -- tax expenditure programs are drafted as the functional equivalents of entitlement programs. That is, in tax expenditure programs, Congress establishes program eligibility criteria which, if the taxpayer claims are met, automatically entitles the program beneficiary to the benefits. This approach parallels that of direct entitlement programs such as food stamps, Medicare, etc. As in the case of direct entitlement programs, tax expenditure benefits are paid out before the Government audits the beneficiary's actual entitlement to the funds.

With the foregoing analytic technique, it is possible to test preliminarily the efficacy of the percentage limitation approach proposed in S.193. Assume that the S.193 approach were applied to limit direct entitlement programs to 30 percent of net revenues. Assume further that Federal revenues in fiscal 1982 were estimated to be $700 billion. For fiscal 1982, therefore, total outlays for entitlement programs could not exceed $210 billion. If revenues for fiscal 1983 rose to $800, entitlement programs could rise to $240 billion without violating the limitation. This result raises the question whether there is a sufficiently rational relationship between direct entitlement program levels and revenues to warrant using revenues as the base figure. Obviously, in the above example, Congress might prefer that entitlement programs receive in excess of 30 percent of the added

revenues in 1983. It might alternatively desire that less than 30 percent of the added revenues go to direct programs and here the danger might be that the 30 percent ceiling in fact would prove to be a floor as well.

The same issues must be faced in applying a limitation to tax expenditures based on revenues. Just because revenues go up by $100 billion, why should tax expenditures be permitted to rise by $30 billion? In short, does Congress really wish to commit itself to the proposition that as much as 30 percent of revenues can be expended via the tax expenditure mechanism?

There are thus two related questions which the Committee must consider: First, does an aggregate limitation technique represent a sound budgetary approach to limiting Federal spending, whether tax or direct? Second, if so, is the net revenue figure the most desirable base or would another base, such as GNP, produce more rational results.

If the basic limitation approach proposed by S.193 does appear desirable, some technical questions do need to be addressed. The proposed amendments speak in terms of "the level of revenue loss from tax expenditures contained in the resolution." At the present time that figure is not set forth in the Budget Resolutions. Consideration should be given to whether existing Budget Act provisions authorize the Budget Committees to include the tax expenditure figure in the body of the Budget Resolutions or whether additional statutory authority is required for that action.[24]

Moreover, it must again be recognized that the revenue figure and the tax expenditures figure are to a significant extent functions of each other. Thus, suppose that the revenue level is set at $800 billion and under existing law tax expenditures will total $260 billion, thus exceeding the limit by $20 billion. If tax expenditures are cut by the requisite $20 billion, revenues will rise to $820 billion, therefore permitting $246 billion in tax expenditures rather than $240 billion, and so on. The situation is reversed if the tax expenditure total is below the limit. These circles can obviously be solved by a simultaneous equation, but it may be questioned whether Congress and the public generally will find that approach to budget preparation a readily understandable one.

While I do have reservations about the efficacy of the limitation approach in S.193, I believe that the procedural changes contained in the second part of the bill would represent a significant advance in the ability of Congress more effectively to control the aggregate level of tax expenditures, to devise more efficient programs where the tax route is followed, and to coordinate tax and direct spending programs. Under present procedures, the tax writing committees act as both the authorizing and the appropriations committees when they approve new or increased tax expenditures. The necessary checks simply are not present to determine whether a tax expenditure program is duplicative of or even consistent with direct programs in the same area. The procedure proposed in S.193 would enable the appropriate legislative committees to make the necessary program evaluation and coordination decisions and the Budget Committee would be able to exert greater pressure to prevent unnecessary and undesirable duplication of costs. The sequential

referral procedure in S.193 would represent, therefore, a very positive step forward in more effective Congressional budget control.

As a technical matter, the Committee should consider whether the language in section 6 of S.193 is precise enough in all respects. For example, the referral procedure would be applicable to any bill which "modifies" an existing tax expenditure. As discussed above, any rate change, or a change in the exemption level or zero bracket amount, will "modify" many tax expenditures in the sense of altering the revenue cost of the programs. Presumably, however, it would not be desirable to refer such tax changes to the non-tax committees, although those committees certainly should be alerted to and actively consider the revenue effect of such changes on tax expenditures within their area of legislative responsibility. The referral procedure should formally apply, however, only to measures which change the program structure of existing tax expenditures (and, of course, to new tax expenditures); section 6 should be revised to make this result clear.

V. Toward More Comprehensive Control and Coordination of Tax and Direct Spending

While S.193 is a welcome sign of renewed interest in bringing tax expenditures under more effective control, it still does not appear to provide a sufficiently comprehensive framework within which Congress may deal with the related problems of controlling aggregate spending through the tax system and coordinating tax and direct spending programs. While this is not the occasion to discuss such a framework in depth, I should like to propose for the Committee's consideration the outline of changes in the budget process which I believe offer prospects for fruitful study:

1. The Budget Act should be amended to require that the President's Budget include both the tax and direct spending totals proposed for each budget function. The Congress is, after all, only part of the Budget process. The Executive Branch must be required to exert its responsibility to control and coordinate both types of spending. What is needed is for the President, through the Office of Management and Budget, to give each Executive Branch Department and agency a budget target which it must meet. And that target must be met by totalling both the direct spending programs for which the Department is responsible and the tax expenditures for programs that are in its area of responsibility. For example, the Department of Education should be assigned a spending target which it could meet (1) by reducing direct spending, tax expenditures for education or a combination of both; (2) by substituting one form of spending for the other; and/or (3) by restructuring either form of spending program to make it more cost-effective. Such a procedure would force non-tax Departments and agencies to take much greater responsibility for tax expenditures than presently is the case.[25] While Congress may not desire to force this procedure on the Executive Branch, a requirement that the Budget be submitted in the form suggested above should move in the desired direction.

2. A similar procedure should be adopted for use by Congress in its own Budget process. The Budget Act should be amended to enable the Budget Committees in the Budget Resolutions to set spending ceilings for the various budget functions which include both tax and direct spending. The appropriate legislative committees and appropriations subcommittees would then have to work with the tax writing committees to insure that combined tax and direct spending for a particular function did not exceed the ceiling. Such a procedure would insure that more rational decisions are made concerning whether and to what extent the tax spending or the direct spending route should be taken. The aggregate of both types of spending

could be more effectively controlled. And, as the tax-writing and legislative committees worked together, overlapping tax and direct spending programs could be more readily identified and coordinated.

I fully realize that working out the practical operation of the above proposals would involve adjustments in Congressional Committee jurisdiction. Nonetheless, such an approach appears essential if the American public is to be given the assurance to which it is fully entitled -- that the Federal Government is in fact spending available revenues in the most effective way possible. That objective simply cannot be achieved if the Executive Branch and Congress look only at 75% of total Federal spending run through direct programs and ignore the other 25% run through the tax system. Especially in the proposed referral procedure, S.193 moves to fill that vacuum and deserves support. But it must also be recognized that ultimately more comprehensive approaches must be given the necessary study and consideration.

APPENDIX A

Appendix 1

Numerical Example of Sale-Leaseback Under Present Law

Parties: Corporation X, the nominal lessee, which expects to have no income tax liability in future years
Corporation Y, the nominal lessor, which expects to have income taxable at a 46-percent rate.

Agreement

1. X purchases new equipment having a 10-year ADR life for $1 million.
2. X sells the asset to Y for $1 million. Y pays X $200,000 cash and an $800,000 note. The note is for 15 years (150 percent of ADR life) at 15 percent annual interest and is paid in equal annual installments of $136,800 (that is, a level payment loan).
3. Y leases the equipment to X for 15 years and charges an annual rental of $136,800, which exactly offsets the debt service. Thus, the only money which changes hands between X and Y is $200,000 from Y to X.
4. At the end of the lease, Y sells the equipment to X for $1.

Results

1. X purchases a $1 million asset for $800,000. (X's rental payments and receipt of loan payments do not affect cash flow--because they are offsetting--or tax liability--because X is not in a taxable position.)
2. Y purchases for $200,000 tax savings worth more than $200,000. Y's tax savings year by year are shown below. Y has deductions for depreciation (column 2) and interest paid (column 3), and it has rental income (column 4). Y's net deduction and tax change are shown in columns 5 and 6, respectively. The present value of this stream (discounted at the after-tax rate of 8.1 percent, which corresponds to a pre-tax rate of 15 percent) is $321,000. Thus, by paying $200,000 to X, Y pays $321,100 less in tax, a gain of $121,000 in constant (present) dollars.

Another way to express Y's gain is as follows. If Y had purchased at par a 15-year, 15-percent bond for $200,000, then Y would have (net of tax on interest income) $643,300 after 15 years. On the other hand, if Y invests the tax savings of column 6 at 15 percent, then Y would have (net of tax on interest income) $1,032,700 after 15 years, a gain of $389,400 in comparable (future) dollars.

Benefits and Costs of Leasing to Y
(All amounts in $1,000)

	Deductions				
End of year	Depreciation	Interest paid	Rental income	Net	Change in tax
0	150	0	0	150	-169.0*
1	220	120.0	136.8	203.2	-93.5
2	210	117.5	136.8	190.7	-87.7
3	210	114.6	136.8	187.8	-86.4
4	210	111.2	136.8	184.4	-84.8
5		107.4	136.8	-29.4	13.5
6		103.0	136.8	-33.8	15.6
7		97.9	136.8	-38.9	17.9
8		92.1	136.8	-44.7	20.6
9		85.4	136.8	-51.4	23.7
10		77.7	136.8	-59.1	27.2
11		68.8	136.8	-68.0	31.3
12		58.6	136.8	-78.2	36.0
13		46.9	136.8	-90.0	41.4
14		33.4	136.8	-103.6	47.6
15		17.9	136.8	-119.0	54.7

* Includes regular investment tax credit of $100,000. Lease is executed at end of taxable year.

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APPENDIX B

In recent weeks, General Electric Credit Corp., a unit of General Electric Co., has committed about $250 million for tax breaks on more than $1 billion of equipment that it will lease back to a number of companies. That equals the value of equipment GECC, one of the nation's largest leasing companies, put under lease for all of 1980. "We are kind of staggered," says Gary C. Wendt, vice president and general manager of GECC's commercial and industrial financing division.

In the biggest transaction disclosed so far, International Business Machines Corp. bought as much as $200 million in tax benefits from loss-ridden Ford Motor Co., and nearly $100 million from CSX Corp., a profitable railroad that has more tax credits than it can use this year. IBM also is buying $60 million of credits from B.F. Goodrich Co., and earlier had arranged to buy some from Pacific Southwest Airlines, a unit of PSA Inc. PSA had indicated that its gain would be about $9 million.

IC Industries

IC Industries Inc. said it sold the tax benefits on equipment valued at $93 million from its Illinois Central Gulf Railroad Unit for about $28 million. The buyer wasn't disclosed.

Pacific Southwest Airlines

Pacific Southwest Airlines, a unit of PSA Inc., said IBM bought investment tax credits and tax depreciation associated with 10 DC9 Super 80 aircraft and related equipment. The planes, acquired by PSA, are valued at about $200 million. PSA previously had announced the sale and indicated that the total gain would be about $9 million; PSA had included a $2.3 million gain from the sale in third quarter earnings.

Asarco

Asarco Inc., a mining concern hurt by low metal prices, said it will receive about $32 million in cash relating to about $100 million in mining, smelting and refining equipment. The concern said it received about $26 million in cash relating to about $82 million in equipment under the first closing yesterday. The rest of the transaction will be completed in late December, Asarco said. The buyer wasn't disclosed.

Wheeling-Pittsburgh Steel

Wheeling-Pittsburgh Steel Corp. said it transferred tax benefits on certain equipment to Batus Inc. in return for a cash payment of $25 million to $35 million. The transaction relates to equipment valued at $100 million to $150 million.

Batus is a Louisville-based holding company with interests in tobacco, retail and paper companies.

Phelps Dodge

Phelps Dodge Corp. said it has received $18.7 million in cash from the sale of tax benefits to General Electric Co. The transaction, through General Electric Credit Corp., is associated with $66 million in equipment.

Milwaukee Road

The bankruptcy trustee of the Chicago, Milwaukee, St. Paul & Pacific Railroad, commonly called the Milwaukee Road, said he completed a sale-leaseback agreement that should be valued at $15 million to the carrier over three years. The buyer wasn't identified.

CIT Unit of RCA Offers Lease Tax-Break Package

By a WALL STREET JOURNAL *Staff Reporter*

NEW YORK—C.I.T. Corp., a unit of RCA Corp., is offering smaller companies a chance to get in on the new sale-and-leaseback tax breaks of the new tax code.

If a company borrows money through C.I.T. to buy $100,000 or more of new equipment eligible for tax breaks it doesn't need, C.I.T. will find that company a purchaser for those benefits.

The purchaser of the tax benefits will pay the real buyer 16.1% of the equipment's purchase price. The real buyer keeps the equipment.

In exchange, the tax-break purchaser can deduct depreciation on the equipment from its taxes, in addition to reaping any investment tax credits on equipment eligible for them.

C.I.T. said capital goods purchased must qualify for depreciation over five years under the August Economic Recovery Tax Act's accelerated cost recovery system. That five-year category includes most industrial equipment and machinery, C.I.T. said.

The 16.1% payment is good for purchases made until Dec. 31, C.I.T. said. It hasn't announced the cash percentage for transactions after Jan. 1.

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Leasing Accords Involve Billions in Gear As Initial Round of Tax Credit Sales Ends

A WALL STREET JOURNAL *News Roundup*

Companies continued their rush to set up leasing arrangements under the new tax law before last Friday's deadline.

The transactions are the result of a provision of the Economic Recovery Tax Act of 1981 that allows companies to sell unusable depreciation deductions and investment tax credits to highly profitable companies seeking to reduce their own taxes.

The sellers, for the most part, either have had losses and don't owe any taxes at all, or have a surplus of deductions and credits because of large capital-spending programs.

The law makes it easier for companies to sell their equipment and then lease back the items. The purchasing company gets the tax advantages and the seller gets cash and use of the equipment.

The law applied retroactively to equipment bought between last Jan. 1 and Aug. 13 but only if leasing arrangements were made by last Friday.

The extent of the leasing activity isn't known. "I don't think anyone has any statistics yet and there probably won't be any for a while," said Tom Healey, managing director and head of the project finance group at Dean Witter Reynolds Inc. Mr. Healey said estimates of the value of the equipment involved of $10 billion to $15 billion "seem right to my instinct."

Among companies disclosing last-minute agreements are:

Dun & Bradstreet

Dun & Bradstreet Corp. said it paid about $170 million for the tax benefits on equipment valued at about $600 million. The company said it has entered into transactions with "several companies" but wouldn't identify them.

Chrysler

Chrysler Corp. said it sold investment tax credits and depreciation on almost $150 million of machinery and tooling to General Electric Co. The auto maker said it received about $26 million from the transaction.

Chrysler agreed to the basic arrangement with General Electric before the Treasury Department announced its preliminary rules for the lease arrangements. The transaction almost fell through because the rules didn't seem to offer sufficient protections to buyers of the tax benefits in the event of a bankruptcy by the seller.

The Treasury, under pressure from Chrysler and other financially troubled companies wanting to sell tax credits, agreed to modify the rules last Tuesday. That led to a mad scramble by Chrysler and GE to put their transaction back together by the Friday deadline.

R.S. Miller Jr., Chrysler's executive vice president of finance, said the company plans to consider bids on about $40 million in equipment and tooling it will acquire in the fourth quarter. Sources said GE already has offered to buy the Chrysler credits.

Arizona Public Service

Arizona Public Service Co. said it completed the previously reported sale of tax benefits to General Electric Co. The investment tax credits and accelerated depreciation involve $250 million of equipment at the Cholla power plant. Arizona Public Service said the sale would result in a net benefit of $50.6 million for the utility and enable it to avoid seeking financing this year in the domestic debt market.

Global Marine

Global Marine Inc., an offshore-drilling contractor, said Hilton Hotels Corp. bought depreciation tax credits associated with four offshore-drilling rigs valued at $135 million. Global Marine said the transaction doesn't include the sale of investment tax credits. The companies wouldn't say how much benefit each would receive from the transaction.

Lone Star

Lone Star Industries Inc. said it sold tax benefits to a company it wouldn't identify for more than $60 million in cash. The cement maker said it expects to complete another transfer by year-end that would net another "several million" dollars.

Lone Star said the transaction primarily was related to tax benefits from the expansion and modernization of its Santa Cruz, Calif., cement plant and similar projects at other plants. The company won't disclose the value of the capital expenditures involved, or the effect on earnings.

Republic Air

Republic Airlines said it transferred tax benefits on "certain aircraft and spare engines" that had been placed in service in 1981. Republic didn't disclose the value of the property, but said the transaction produced about $19 million, which the airline used to reduce floating-rate bank debt.

Mitchell Energy

Mitchell Energy & Development Corp. said it sold $18.5 million of investment and accelerated depreciation tax credits. Mitchell wouldn't identify the buyer. Mitchell, an oil and natural gas company and real-estate developer, said the credits were available for sale because of a surplus of tax credits generated from its energy capital program. Cash from the sale will be used to reduce company debt, Mitchell said.

Alaska Air

Alaska Airlines said it sold a Boeing 727 for $14 million to a buyer it wouldn't identify and leased it back for 11 years with a $1 purchase option at the end of that lease. Under this transaction, Alaska Airlines keeps the investment tax credit and the buyer gets accelerated depreciation.

Chicago & North Western

Chicago & North Western Transportation Co. said it completed a sale-leaseback transaction involving sale of tax benefits on property, including locomotives and freight cars, valued at about $53 million. The cash value of the transaction to Chicago & North Western is about $13 million, the railroad said. It wouldn't identify the buyer.

Marsh & McLennan

Marsh & McLennan Co. said it bought tax benefits related to $34 million in capital equipment owned by Boston Edison Co. Boston Edison said it received $6 million cash as part of the transaction. Neither company would estimate the effect of the transaction on earnings.

Marsh & McLennan, an insurance broker, also purchased tax benefits last week from Occidental Petroleum Corp. related to about $95 million of capital equipment. As reported, Marsh & McLennan told analysts that the company's per-share earnings would be increased by three to five cents in 1981 because of the Occidental transaction and by about 50 cents over the 15-year term of the lease.

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N&W Buys $40 Million in Tax Benefits, Moving Against Trend of Rail Industry

A WALL STREET JOURNAL News Roundup

In contrast to several other railroads that recently arranged to sell tax benefits, Norfolk & Western Railway said it bought tax benefits for more than $40 million.

The benefits apply to more than $200 million of equipment from two companies that aren't engaged in railroading, N&W said yesterday.

N&W, a profitable railroad based in Roanoke, Va., declined to identify the two companies involved in the transactions, which were arranged under a provision of the Economic Recovery Act of 1981. An N&W spokesman responded with "no comment" when asked if one of the concerns was Flexi-Van Corp., a New York-based lessor of van-sized containers and trailers.

On Friday, Flexi-Van had announced the sale of $120 million of tax credits and tax deductions on equipment.

National Steel

National Steel Corp. said it sold tax credits on various assets valued at about $60 million. National Steel disclosed neither the price nor the buyer. However, EG&G Inc., a high-technology company based in Wellesley, Mass., said it bought $20 million in tax benefits from National Steel on equipment for processing steel and aluminum.

Scott Paper

Scott Paper Co. said it received about $42 million in cash from the sale of tax benefits on equipment. The buyer wasn't disclosed. The company said proceeds will be used for plant modernization and expansion.

Cleveland Electric

Cleveland Electric Illuminating Co. said it received $23.2 million for tax credits and depreciation deductions on about $116 million of electric utility equipment. The benefits were bought by a unit of Standard Oil Co. (Indiana). Cleveland Electric said the transaction with Amoco Tax Leasing Corp. will improve its cash position by reducing its current need to borrow money at high interest rates and by deferring the need to raise long-term capital.

Thermo Electron

Thermo Electron Corp. said it paid $13.8 million for tax benefits on equipment valued at $65 million. The Waltham, Mass., maker of process equipment and environmental monitoring instruments wouldn't identify the seller.

Continental Airlines

Continental Airlines said it received $24 million on the sale of tax benefits on $94 million in assets to Metromedia Inc.

Los Angeles-based Continental said the benefits consist mainly of investment tax credits that it couldn't have used for several years because of recent losses.

United Cable

United Cable Television Corp., Englewood, Colo. said it sold tax benefits from $36 million of installed cable television networks to Consolidated Freightways Inc. for $5.8 million.

Watsco

Watsco Inc., a Hialeah, Fla.-based maker of cooling, heating and solar-energy parts, said it paid a unit of Pantry Pride Inc. $750,000 for tax benefits on assets valued at about $6 million.

Great American

Great American Industries Inc. said it bought tax benefits on $25 million of equipment from Oxford Resources Corp., a unit of Trexar Corp. Great American, based in Binghamton, N.Y., didn't disclose the price.

Pan Am

Pan American World Airways said it sold for $47 million tax benefits on four Lockheed aircraft. Pan Am wouldn't identify the buyer.

The airline said the terms of the agreement called for the buyer to pay $15.6 million in cash. The $31.4 million balance will be invested by the buyer according to Pan Am's directions and paid over 18 years with the interest earned, a spokeswoman said.

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Metromedia Purchases Credits, Deductions On $350 Million in Gear

A WALL STREET JOURNAL News Roundup

Metromedia Inc. said it paid about $80 million for investment tax credits and depreciation deductions on about $350 million in equipment.

The company didn't identify the sellers but said they include several public and closely held concerns.

The purchase was made under the liberalized leasing provisions of the 1981 tax law that allow companies to sell unusable tax breaks to profitable concerns seeking to reduce their federal taxes. The broadcasting company previously reported a transaction with New York's Metropolitan Transportation Authority, in which Metromedia bought buses and railroad cars to gain a $102 million tax break over the next five years. Metromedia agreed to pay $15.5 million and the MTA retained use of the equipment by leasing it back from Metromedia.

Metromedia's announcement follows a flurry of agreements reached before a deadline last Friday for taking advantage of a retroactive provision in the new law. The provision allowed companies to arrange sale-leaseback agreements on equipment purchased between Jan. 1 and Aug. 13, when the law took effect.

Among the companies announcing agreements yesterday were:

LTV

LTV Corp., Dallas, said its Jones & Laughlin Steel Inc. unit sold for about $33 million tax benefits of $100 million relating to steelmaking equipment. The buyer wasn't identified.

Moore McCormack

Moore McCormack Resources Inc., a Stamford, Conn., steamship operating and mine managing concern, sold its investment tax credits on a ship to an oil company for $19 million. Moore McCormack didn't disclose the buyer.

Foote, Cone & Belding

Foote, Cone & Belding Communications Inc. said it bought about $10 million in tax benefits from three companies. The Chicago-based international communications and advertising concern wouldn't identify the sellers.

Worldwide Energy

Worldwide Energy Corp. said it sold for about $700,000 tax benefits on $2 million of equipment under a sale-leaseback agreement. The Denver-based concern said that under proposed financial accounting standards, the sale will contribute about $300,000 to fourth quarter earnings. The buyer wasn't disclosed.

Amax

Amax Inc. said it will receive about $23.5 million in cash from the sale of tax benefits related to about $85 million of equipment. The Greenwich, Conn., natural resources concern said it already has received $19.8 million cash under the first closing last Thursday, and the rest of the transaction will be completed next month.

Amax, which didn't identify the buyer, said it will use the proceeds to reduce borrowings and related interest costs.

Dynalectron

Dynalectron Corp. said it bought about $670,000 in tax credits, related to about $3.5 million in equipment, from three companies. The McLean, Va.-based technological services concern, said that the transactions were completed last Friday and that it will lease back the equipment over 10 years. The sellers weren't identified.

Ohio Edison

Ohio Edison Co. said it sold tax benefits for about $36 million. The Akron-based utility said the first part of the transaction, for $29 million, was completed last week, and the second part is expected to be completed in December.

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NOTES

1. Figures in the text were derived from Congressional Budget Office, Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-1986 (Sept., 1981) Table 1, pp. 34-35 (hereafter referred to as "1981 CBO Report"); Tax Foundation, Facts and Figures on Government Finance (20th Biennial ed., 1979) at 33 (hereafter referred to as "1979 Tax Foundation").

2. Budget of the United States Government, Fiscal Year 1982 at 22, 612.

3. Id.

4. Concern over this phenomenon has been expressed in recent months both in and out of Congress. See, e.g., Statements of Senator Baucus, 127 Cong. Rec. S1590, S1811, and S2078 (daily ed. Feb. 26, Mar. 5, Mar. 12, 1981); Editorial, The Washington Post, "The Other Kind Of Spending," Apr. 3, 1981, p. A14; Rowan, Where To Make Cuts: Start With Tax Shelters, The Washington Post, Mar. 19, 1981, p. A23.

5. The text figures are derived from Staff of The Joint Committee on Taxation, Summary of H.R. 4242, The Economic Recovery Tax Act of 1981 (Jt. Comm. print, Aug. 5, 1981) Table 2, pp. 58-63. It is unclear to what extent the revenue losses from tax straddle transactions were included in prior tax expenditure budgets.

6. I.R.C. §168(f)(8).

7. See The Senate Finance Committee Report on the 1981 Act, S. Rep. No. 97-144, 97th Cong., 1st Sess. 61-63 (1981).

8. Office of Management and Budget, Special Analysis G, Budget of the United States Government, Fiscal Year 1982 at p. 224, applying the text analysis to the refundable portion of the earned income credit.

9. The cost of the SHL program is treated as a revenue reduction; see id. as to the nonrefundable portion of the earned income credit.

10. See e.g., Wall Street Journal, Nov. 19, 1981, p. 6.

11. Joint Committee on Taxation, Safe Harbor Leasing Provisions Under Accelerated Cost Recovery System (Oct. 20, 1981) Appendix 1.

12. See the examples in Appendix A, which have appeared in The Wall Street Journal.

13. More extensive discussions of the examples discussed in the text are contained in Surrey and McDaniel, The Tax Expenditure Concept and the Budget Reform Act of 1974, 17 B.C. Ind. & Comm. L. Rev. 679 (1976); Surrey and McDaniel, The Tax Expenditure Concept: Current Developments and Emerging Issues, 20 B.C.L. Rev. 225 (1979).

14. See 1981 CBO Report at 51-53.

15. McDaniel, Institutional Procedures for Congressional Review of Tax Expenditures, 8 Tax Notes 659 (1979).

16. See 1981 CBO Report at 55-57.

17. McDaniel, Tax Expenditures and Federal Spending Limitations, 10 Tax Notes 475 (1980).

18. See Statement of Representative Daschle, 127 Cong. Rec. H8177 (daily ed., Nov. 5, 1981).

19. See Statement of Representative Bonior, 127 Cong. Rec. E5104 (daily ed., Nov. 4, 1981).

20. S. Res. 326, 95th Cong., 1st Sess. (1977).

21. See Statement of Senator Biden, 127 Cong. Rec. S1623 (daily ed., Feb. 26, 1981).

22. S.193, 97th Cong., 1st Sess. (1981) §§2-5.

23. Id. §6.

24. It is arguable that the requisite statutory authority already exists by virtue of §301(a)(6) of the Budget Act which provides that the First Budget Resolution shall contain not only the recommended levels of revenues, etc., but also "such other matters relating to the Budget as may be appropriate to carry out the purposes of [the Budget] Act."

25. The proposal described in the text should mitigate the all too frequent practice of non-tax Departments indiscriminately supporting tax expenditures because they are at the limits of their allocable share of direct outlays.

The system described in the text parallels the "envelope system" presently employed in Canada. See The New Expenditure Management System, A Paper Outlining the Envelope System for Allocating and Controlling Expenditures of the Government of Canada (December, 1979).

Senator KASSEBAUM. I would like to ask you for a comment on the Canadian plan.

GREATER CONTROL ACHIEVED IN TAX DEDUCTIONS BY CANADIAN PLAN

Have they had a rapid escalation in the tax deductions as we have had?

Mr. MCDANIEL. They were up until the first tax expenditive budget was published in 1979.

Senator KASSEBAUM. This just went into effect in 1979?

Mr. MCDANIEL. Yes.

Senator KASSEBAUM. It has brought some degree of control?

Mr. MCDANIEL. At least according to informal reports. I don't think there has yet been a systematic study. It is probably too early yet. Reports from those who have participated in the process, indicate that they feel that greater control is being achieved.

Senator KASSEBAUM. I would just offer a further comment on the shelter leasing agreement.

I feel relatively sure, with all the controversy following their enactment we will see further consideration and change. I do think that we simply had no idea what we wrought with that. As in the case of Occidental, a company whose earnings topped $700 million last year, selling their tax credits to an insurance company. I just don't see this as benefiting the economy.

Mr. MCDANIEL. Yes; one footnote on that. The safe harbor rule is not going to benefit just loss corporations. It benefits any "no tax" corporation. One can be in a no U.S. tax situation because of foreign tax credits, for example. Thus, I think you are going to find another big group of sellers in this area are those that have problems with foreign tax credit limitations.

Senator KASSEBAUM. You really had a troubled business, like Chrysler for instance, would it not almost be better to go to a direct subsidy?

Mr. MCDANIEL. Yes. At least it seems to me you could have a chance of avoiding the kind of waste present in this form of subsidy.

Senator KASSEBAUM. Better chance of analyzing how it is going to be used.

I think your point on spending limitations is interesting. I believe this is one reason why we should not pass a constitutional amendment for a balanced budget. As we try to set an overall limit on spending, we try to find ways around it, using either off-budget devices and or tax subsidies.

Mr. MCDANIEL. I agree with you.

SPENDING LIMITATIONS COULD ESCALATE TAX SUBSIDIES

Senator KASSEBAUM. And I will guess if we tried to put spending limitations on we are going to see, unless we direct ourselves to this question, a further escalation of tax subsidies.

Mr. MCDANIEL. Yes; I think that with respect to Senator Moynihan's proposal, for example, the committee has to be aware of the phenomenon you described earlier. Suppose, for example, that tax expenditures are anticipated to be $240 billion, but the limit placed

in the budget only $200 billion. You do have to recognize the Finance Committee may be able to reach that objective without changing the tax expenditure provisions at all. Any rate reduction will automatically reduce tax expenditures and, thus, I think some attention needs to be focused on that phenomenon to decide what kind of limit it is you want to use.

Senator KASSEBAUM. If all of a sudden we just could get to it all at once, then we wouldn't have that anguish over what we should do, what deduction should be eliminated and so forth, I am sure.

Do you see any benefit in a system that would be extremely simplified taking this to the ultimate, such as a flat tax with no deductions?

Would this ever be a workable system?

Mr. MCDANIEL. I doubt that we will ever get to a flat tax with no deductions. I suspect, for example, that we will always want to have some sort of exemption level for individuals in order to take into account poverty levels and family size.

Once any exemption is employed, you are automatically in a two-rate system. I think the question of how many brackets are desirable is a worthwhile question. I would doubt we would ever get to a system in which no one got a personal exemption, no one got a standard deduction. I just doubt many people would find that an attractive system.

Senator KASSEBAUM. Thank you very much, Professor McDaniel.

I know you have given lots of expert advice in this area, and appreciate your coming to testify today.

[Whereupon, at 3:55 p.m., the committee was adjourned.]

97TH CONGRESS
1ST SESSION

S. 193

To amend the Congressional Budget Act of 1974 to establish a ceiling on revenue loss from tax expenditures, to require authorization of new tax expenditures, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JANUARY 22 (legislative day, JANUARY 5), 1981

Mrs. KASSEBAUM introduced the following bill; which was read twice and referred jointly, pursuant to the order of August 4, 1977, to the Committees on the Budget and Governmental Affairs with instructions that if one committee reports, the other committee has thirty days of continuous session to report or be discharged

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A BILL

To amend the Congressional Budget Act of 1974 to establish a ceiling on revenue loss from tax expenditures, to require authorization of new tax expenditures, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Tax Expenditure Limitation and Control Act of 1981".

SEC. 2. Section 301 of the Congressional Act of 1974 (31 U.S.C. 1332) is amended—

(1) by redesignating subsections (c), (d), and (e) as subsections (d), (e), and (f) respectively; and

(2) by inserting after subsection (b) the following new subsection:

"(c) LEVELS OF REVENUE LOSS.—It shall not be in order in either House to adopt the first concurrent resolution on the budget for any fiscal year if the level of revenue loss from tax expenditures contained in the resolution exceeds 30 percent of the recommended level for net revenue set forth in such resolution.".

SEC. 3. Section 304 of the Congressional Budget Act of 1974 (31 U.S.C. 1325) is amended by adding at the end of the section the following new subsection:

"(b) LEVELS OF REVENUE LOSS.—It shall not be order in either House to adopt a concurrent resolution on the budget under subsection (a) if the level of revenue loss from tax expenditures contained in the resolution exceeds 30 percent of the recommended level for net revenue set forth in such resolution.".

SEC. 4. Section 310 of the Congressional Budget Act of 1974 (31 U.S.C. 1331) is amended—

(1) by redesignating subsections (b) through (f) as subsections (c) through (g) respectively, and

(2) by inserting after subsection (a) the following new subsection:

"(b) LEVELS OF REVENUE LOSS.—No concurrent resolution on the budget required to be reported under subsection (a) may be reported in either House, and it shall not be in order for either House to adopt such resolution, if the level of revenue loss from tax expenditures contained in such resolution exceed 30 percent of the recommended level for net revenue set forth in such resolution.".

SEC. 5. (a) Section 309(1) and section 311(a) of the Congressional Budget Act of 1974 (31 U.S.C. 1330(1) and 1332(a)) are amended by striking out "section 310(c)" and inserting in lieu thereof "section 310(d)".

(b) Subsections (e)(1), (e)(2) and (f) of section 310 of such Act (31 U.S.C. 1331(e)(1), (e)(2), and (f)) are amended by striking out "subsection (c)" and inserting in lieu thereof "subsection (d)".

SEC. 6. Title IV of the Congressional Budget Act of 1974 is amended by adding at the end thereof the following new section:

"BUDGET AUTHORITY FOR TAX EXPENDITURES

SEC. 405. (a) AUTHORIZATION REQUIREMENT.—It shall not be in order for either the House of Representatives or the Senate to consider any bill or resolution, or any amendment to any bill or resolution, which enacts a new tax expenditure or expenditures, or modifies an existing tax expenditure or expenditures, unless such bill, resolution, or

amendment has been referred in the House or Senate, as the case may be, to the committee which has jurisdiction over the activity which such tax expenditure affects, or is intended to affect, and sequentially to the Committee on the Budget of the House or the Senate, as the case may be, and unless such committees have favorably reported such bill, resolution, or amendment for consideration to, as the case may be, the House or the Senate.

"(b) REQUIRED REPORTING DATE.—Except as otherwise provided in this section, it shall not be in order in either the House of Representatives or the Senate to consider any bill or resolution which, directly or indirectly, authorizes the enactment of a new tax expenditure or expenditures, or authorizes the modification of an existing tax expenditure or expenditures for a fiscal year, unless such bill or resolution is reported in the House or Senate, as the case may be, in accordance with the provisions of subsection (a) of this section, on or before May 15 preceding the beginning of such fiscal year.

"(c) WAIVER IN THE SENATE.—The provisions of section 402(c) of the Congressional Budget Act of 1974 shall apply to any bill or resolution reported under subsections (a) and (b) of this section.".

STATEMENT OF FRED WERTHEIMER, PRESIDENT, COMMON CAUSE

Common Cause appreciates this opportunity to present our views on the issue of tax expenditures -- those revenue losses which are attributable to provisions of the federal tax laws allowing a special exclusion, exemption, or deduction from gross income or providing a special credit, preferential rate of tax, or a deferral of tax liability. We would particularly like to recognize the efforts of Senator Kassebaum in bringing the issue of congressional oversight of tax expenditures to the attention of this Committee. In both this session and the last Congress, she has played an effective leadership role on this issue, and we are pleased to add our views to the Budget Committee's consideration of her proposal.

This Congress, as members of this Committee are all too painfully aware, has been marked by long and extensive debate about the levels of spending which are appropriate for the federal government. This Committee has been given the overall responsibility of deciding which federal programs and subsidies will receive less federal funding.

Yet in the midst of unprecedented reductions in federal spending, the fastest growing area of federal spending has largely escaped the careful scrutiny of the Administration and Congress. While cuts in direct spending and loan programs in the last eleven months have totalled $36 billion, virtually no attention has been devoted to federal tax expenditures.

When the Administration announced the specifics of its economic recovery program earlier this year, the Director of the Office of Management and Budget announced that the thundering

herd of sacred cows had been reduced to a handful. But when it came to tax expenditures, the Administration was much less successful in rounding up the strays. Two hundred and sixty-six billion dollars in tax expenditures were left untouched by the Reagan Administration's budget ax. In fact, when the bidding war was finished, the Economic Recovery Act of 1981 authorized an additional $13 billion in new tax expenditures for fiscal year 1982. This increase raises projected 1982 tax expenditures to a total of $279 billion -- the equivalent of 40 percent of the $695 billion in direct spending allocated for the entire 1982 federal budget.

The lack of Administration and congressional attention to tax expenditures has produced the following anomalies:

- Government spending to subsidize housing for low-income families was reduced for 1982, but tax expenditures encouraging home ownership were untouched.
- While the federal government has reduced by one-third its program to warn Americans about the health risks of smoking, the tax system will continue to support advertising for tobacco products.
- Although children from middle income families will lose eligibility for federally funded lunch programs, tax benefits will continue to flow to corporate employees who lunch at the partial expense of all taxpayers.
- Federal assistance to conserve energy and develop new sources will be trimmed while oil companies continue to receive tax incentives to produce profitable conventional energy sources.
- Cutbacks in Urban Development Action Grants will reduce government efforts to stimulate private sector economic development, but Industrial Development Bonds (IDBs), which pursue the same goal by making tax-exempt low-cost financing available to private firms, remain untouched, in spite of evidence that IDBs are used by profitable firms, stretching the original intent of the subsidy.

(These examples and other portions of this testimony are drawn from a recent Common Cause study, entitled The Untouchables, which is attached.)

The increases in tax expenditures enacted in 1981 are by no means unusual; these preferences have been a major growth area in federal spending policy over the last decade. For example:

- Over the past ten years, tax expenditures have increased by 343 percent.
- Since 1975 revenue losses resulting from tax expenditures have risen 14 percent a year, outpacing the 11 percent annual increase in direct spending.
- Between 1980 and 1981 alone, tax expenditures grew nearly 20 percent.
- In 1968 there were 40 separate tax expenditures; today there are over 100.
- The new $13 billion in tax expenditures added to the 1982 budget will grow to $88 billion in revenue losses to the 1986 federal budget if left untouched over the next five years.
- The Joint Committee on Taxation estimates that by FY 1986 tax expenditures will drain $553 billion from the Treasury, more than doubling the loss in FY 1981 and amounting to 50 percent of that year's federal budget.

The explosive growth in tax expenditures is due in part to the failure of Congress as an institution to give coordinated consideration to this form of government spending. Proposals to establish new federal direct spending programs, for example, receive fairly careful congressional consideration. Standing committees with expertise in a given subject area approve authorizing legislation. The appropriations committees weigh conflicting demands and provide funding for authorized programs. All of these decisions are made within the confines of the budget process.

There is, however, no comparable system for congressional consideration of tax expenditures. There is no periodic authorization; the tax law contains no statement of objectives, and there rarely is an evaluation of performance. There is no review as part of the appropriations process; most tax expenditures are self-executing and require little or no funding for implementation. And as Senator Kassebaum has written, "I would suggest that the most discouraging aspect of our otherwise commendable effort to fulfill the Senate's budgetary responsibility has been our inability to exercise effective control over the revenue-raising side of the budgetary process. While we have made great progress in our ability to monitor and regulate direct spending, our progress in coming to grips with issues relating to taxation has been practically nonexistent."

Despite the differences in congressional consideration of tax expenditures and direct spending programs, there is little difference in their effect. Both types of government activity are designed to accomplish specific goals. Both cost the federal government money -- spending programs directly and tax expenditures indirectly, through revenues foregone. Both contribute to the national debt; reducing revenues through tax expenditures adds to the federal deficit as surely as direct spending does. As Representative Sam Gibbons (D-FL) has observed, "These tax expenditures are as much a subsidy to the taxpayer as if the government had written a check to the taxpayer out of the taxes it lected."

Tax expenditures are often promoted by groups and organizations which are unable to secure direct federal funding for their programs. As long ago as 1959, economist Walter Heller observed:

> The back door to government subsidies marked 'tax relief' is easier to push open than the front door marked 'expenditures' or the side door marked 'loans, guarantees and insurance' . . .
>
> The very groups that use this back door are often among the most insistent advocates of responsible and informed government budgeting. Yet here is a whole catacombs of government benefits which are largely hidden from public view, let alone, periodic review.
>
> Once embedded in the tax structure, the preferential provisions are treated as inablienable vested rights, impervious to changes in tax rates, economic policy, and technology.

Getting a tax benefit is often better than getting a grant or loan from the government. Once a tax benefit is enacted, there is a minimal chance of oversight and an even smaller chance that the benefit will be taken away.

Many tax expenditures meet legitimate public policy objectives in a cost effective and efficient manner. But we believe that <u>all</u> tax expenditures should be subject to thoughtful congressional consideration and review. Some tax expenditures perform well; others are out of date, inequitable, and inefficient. Yet all are essentially shielded from what the Congressional Budget Office calls the "budget visibility and accountability" focused on direct spending and loan programs.

Common Cause believes that it is time to end this privilged status for tax expenditures. Institutional changes must be made

to ensure that tax expenditures which are enacted are subject to the same scrutiny as spending programs. This Committee is considering S. 193, the Tax Expenditure Limitation and Control Act introduced by Senator Kassebaum; the Committee also has before it S. 582, the Tax Expenditure Control Act of 1981, sponsored by Senator Biden. In designing a process for improving congressional consideration of tax expenditures, we urge the Committee to to support the following proposals:

1. Standing committees of the House and Senate with jurisdiction over direct spending programs should automatically review tax expenditures affecting their areas. The present lack of involvement and analysis by the standing committees regarding tax committee proposals impedes any effort to coordinate federal efforts in a given policy area. Providing automatic review of proposed tax expenditures by these committees would give the Senate and House an opportunity to assess tax proposals in light of direct spending programs, determine whether efforts in both are complementary or conflicting, and decide whether when taken together, these direct and indirect spending programs exceed the amount of resources that should be devoted to a particular activity.

2. The Budget Committees of the House and Senate should also review tax expenditures. The Budget Committees are responsible for determining the parameters of federal spending and federal revenue-raising efforts. These considerations must include a timely examination of new tax expenditure proposals. As former

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Senators Muskie and Bellmon have written, "Failure to take tax expenditures into account in the budget process would be to overlook significant segments of Federal policy. They should be given particularly thorough scrutiny because, tax expenditures are generally enacted as permanent legislation and thus are comparable to continuing direct spending entitlement programs, often with increasing annual revenue losses."

3. Tax expenditures should be subject to a sunset process. Once enacted, tax expenditures generally become permanent fixtures of our tax laws. A Common Cause study (Gimme Shelters) of 1978 tax expenditures found that only about 10 percent of the number of tax expenditures (comprising 3.2 percent of the dollars spent through the tax expenditure budget) are authorized by tax provisions that are not permanent. The automatic termination of existing tax expenditures--and a ten-year limit for any new tax expenditure--should be required to ensure congressional evaluation of actual performance. A periodic review and reconsideration of tax preferences is needed to assess whether the tax expenditure has met its goals, needs to be adjusted or altered, or should be allowed to terminate.

Common Cause has consistently advocated a sunset statute which would apply to federal spending programs as well as tax expenditures. Such a comprehensive approach would force Congress to consider and evaluate total federal spending efforts-- direct spending and tax expenditures--within specific policy areas.

At the end of 15 years of service as Comptroller General, Elmer Staats reported, "While many . . . tax expenditures help

to implement important public policy goals, I can only urge that the Administration and Congress subject tax expenditures to the same careful scrutiny afforded direct expenditures."

As each federal dollar is squeezed tighter and tighter, the President and Congress can no longer afford to ignore the rising costs of tax expenditures. We urge this Committee to take steps now to bring these heretofore untouchables under control.

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